

103

DISCRIMINATION IN SURETY BONDING

Y 4. SM 1:103-36

Discrimination in Surety Bonding, S...

HEARING

BEFORE THE
SUBCOMMITTEE ON MINORITY ENTERPRISE,
FINANCE, AND URBAN DEVELOPMENT
OF THE
COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES
ONE HUNDRED THIRD CONGRESS
FIRST SESSION

WASHINGTON, DC, JULY 20, 1993

Printed for the use of the Committee on Small Business

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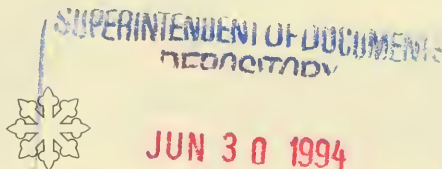
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DISCRIMINATION IN SURETY BONDING

TUESDAY, JULY 20, 1993

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON MINORITY ENTERPRISE,
FINANCE, AND URBAN DEVELOPMENT,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2359-A, Rayburn House Office Building, Hon. Kweisi Mfume (chairman of the subcommittee) presiding.

Chairman MFUME. Ladies and gentlemen, we will go ahead and begin. I will recognize Members as they arrive for opening statements. Mine is rather lengthy, so I will consume time ordinarily reserved for other Members.

Let me officially welcome all of you here. The Subcommittee on Minority Enterprise, Finance, and Urban Development will examine this morning issues involving access to surety bonding by qualified small and minority construction contractors. Given the complex nature of the surety business, today's hearing will be confined to a discussion of surety bonds for public construction projects.

To put this debate into proper context, it will be useful to have a general understanding of what a surety bond is, who the parties to this instrument are, and what their respective obligations are. For purposes of our discussion today, a surety bond is an instrument provided by a surety company to a contracting officer for the Federal Government, which guarantees that a contractor will complete a construction project, complying with all terms and conditions contained in the contract.

By assuming the risk of performance default by the contractor, the surety company, through the bonding instrument, gives the contracting officer assurance that the project will be completed and all associated bills will be paid. The contracting officer has a concomitant obligation to pay the contractor according to the terms and conditions of the contract.

Finally, the contractor is liable to the surety for any default on performance on the contract, and in the case of a payment bond, liability extends to default by the contractor on outstanding amounts owed by the contractor to suppliers and subcontractors.

Due to congressional concerns over the high failure rates of contractors on public works projects during the Great Depression, Congress enacted the Miller Act of 1935. This act requires that all prime contractors post performance and payment bonds on all Federal contracts valued at \$25,000 or more. This prequirement highlights the importance of the hearing today, because access to surety

bonding largely determines whether or not a contractor will have access to public construction contracts.

Just as there are varying types of construction contractors and public works projects, there are different types of surety companies, and different types of bonds required for these projects. At the risk of oversimplifying the process, most companies that issue surety bonds work through agents and brokers, also known as producers. Surety bond underwriters on public projects are licensed by the States through their insurance departments and are approved by the U.S. Treasury Department. The first step for a contractor seeking bonding then, is to identify a surety agent, who is also licensed by the State, and responsible for assisting the contractor in preparing and presenting the necessary information to a surety underwriter. This agent, or producer, in "prequalifying the contractor for a business relationship with the surety company, should know enough about each party to create the right match."

Small and minority contractors have consistently cited difficulties in obtaining satisfactory bonding arrangements as the principal barrier to their ability to bid on Federal, State and local construction jobs. Legislation has been introduced by Congresswoman Eleanor H. Norton this session to prohibit discrimination in any aspect of the bond transaction.

The debates surrounding surety bonding are reminiscent of debates in Congress during the early 1970's when studies began to surface which purported to demonstrate the existence of red lining by lending institutions. The practice of red lining is recognized as systematic institutional racial discrimination. Some would argue that the same type of systematic racial discrimination exists to some extent in the surety bonding industry.

While I would reserve any personal indictment against the entire industry at this time, let me suggest that similarities between a banker's ability to make arbitrary credit decisions and a surety producer or an underwriter's capability of injecting personal prejudice into the bonding process, are compelling indeed.

When Congress first debated imposing lending disclosure requirements on financial institutions, most lenders denied any culpability and suggested that they were in fact providing credit in a manner that was consistent with prudent lending practices.

Some in the surety industry today argue that there is sparse evidence to support charges of discrimination, and that these allegations are at least inflated and totally, as many have come to say to this committee, without merit.

Financial institutions, over 15 years ago, argued that the increased paperwork resulting from disclosure requirements would place undue burdens on them and their institutions.

Some in the surety bonding industry today have expressed the same concern about burdensome paperwork from disclosure requirements in currently pending legislation. Surety agents and producers have argued that it is in their economic best interests to complete the transaction. Bankers in the 1970's made the same claim, yet we now have documented evidence that clearly repudiates that logic or that argument.

Given the volume of court rendered decisions finding continuing discrimination in banking, in education, in voting, in housing and

employment—absent some compelling evidence to the contrary—it seems fair to infer that race and ethnicity play some role, no matter how minimal, in business decisions made by surety bond agents and/or underwriters in determining whether or not a firm will receive the bonding necessary to participate in a Federal construction project.

Some in the surety industry have argued that pending legislation also would subject them to civil liability suits, should a contractor be denied surety credit on what could be construed as questionable grounds.

To this argument, I would simply counter that if the surety transaction process which, as we know, is so crucial to the growth and development of small, minority and women-owned business construction firms is tainted with even a hint of discriminatory bias, those participating in this violation of a most fundamental component of civil rights, should be made to fully suffer the consequences of what we feel is an unconscionable deed.

Today we have a veritable cross-section of interested parties here to discuss this timely and critical issue and to add to this debate. We have representatives of the surety agents or producers, representatives of the surety bond companies, representatives of minority construction contractors and a minority contracting company and a representative also in Congress who should be joining us later, who has pending legislation that I have referred to that would in fact affect the relationship between all of the parties here before this subcommittee today.

Before I introduce our first witness, I must advise witnesses, as I will advise Members, when they do arrive, that the constraints on our time require that we proceed today under the 5-minute rule. I will ask, therefore, that witnesses attempt at least to limit their oral presentations to 5 minutes.

All written testimony will be submitted, without objection, to become part of the hearing record. The hearing record will be kept open for 5 legislative days to permit additional testimony from individuals who are not present today and to allow subcommittee members the ability to revise and extend their remarks.

[Chairman Mfume's statement may be found in the appendix.]

Chairman MFUME. We do have with us Congresswoman Lucille Roybal-Allard, who is from the State of California, the 34th congressional District. Ms. Roybal-Allard, I will defer to you in the absence of a Minority Member at this time if you have some opening remarks.

Ms. ROYBAL-ALLARD. In the interest of time, I will submit my statement for the record. I look forward to the testimony.

[Ms. Roybal-Allard's statement may be found in the appendix.]

Chairman MFUME. Thank you very much. We are taking our panel a bit out of order because of a conflict, quite frankly, with the schedule of Delegate Eleanor Holmes Norton, who will be arriving and will for all intents and purposes, then be the second panel.

On the first panel we have Arnold Acker, chief executive officer, Forcon International; Christopher St. Ange, vice president, C&C Piping & Welding Co.; and John B. Cruz, III, president, John B.

Cruz Construction Co. and Michael J. Sugar, president of Forcon International.

Go right ahead, Mr. Acker.

**TESTIMONY OF ARNOLD ACKER, CHIEF EXECUTIVE OFFICER,
FORCON-AACON, INC., ACCOMPANIED BY MICHAEL J. SUGAR,
PRESIDENT OF FORCON INTERNATIONAL**

Mr. ACKER. Good morning. My name is Arnold Acker of Forcon-Aacon, an affiliate of Forcon International Corp., represented here today by Mr. Michael Sugar.

I would like to present a program that would afford qualified small and minority construction contractors the ability to obtain bonding with significantly reduced risk to bonding companies.

We refer to this program as disbursement control. Construction disbursement control is a highly effective technique for preserving the linkage between contract income and costs. Prompt progress payments to subcontractors and suppliers is a critical element in the timely completion of a construction project.

Direct linkage between contract income and costs is a trust obligation of a contract subject to numerous Federal, State, and local statutes, and regulations.

The disbursement control process itself, basic to the disbursement control is the absolute control of all project funds. This control program is initiated simultaneously with the award of a contract by the signing of the disbursement control agreement between the contractor and the third party disbursement control agent.

The agreement implements the assignment of all project draw proceeds from the owner to a project specific disbursement bank account. This project specific disbursement account is opened under the Federal ID number of the contractor. The title of this account is in the name of the contractor, and the disbursement control agent is listed as a secondary account holder. The funds are then locked up pursuant to the disbursement agreement.

Throughout the project, the contractor is required to supply draw request information, including original invoices and copies of sub-contract agreements and purchase orders to the disbursement control agent.

As the contractor's draw proceeds are received by the disbursement control agent, they are deposited directly into the project specific disbursement account. All invoice data previously input into the cost accounting system then generates checks made payable to subcontractors, suppliers and to the contractor himself, resulting in the prompt payment of vendors.

Additionally, strict adherence to certified payrolls and paid tax receipts for payroll taxes is required.

How does the Government benefit? Disbursement control opens the market to otherwise unbondable contractors and subcontractors. The construction market as a whole becomes more accessible to new, small, or disadvantaged contractors.

Equally important, disbursement control reduces accounts payable risk and provides a tested early warning system if construc-

tion costs exceed contract income. Contract income is preserved and the ability to address problems or failures is expedited.

Additionally, reliable project specific job costing records are available from the independent third party to facilitate change order negotiations and owner audits.

In the process, small, disadvantaged and minority contractors are being given the opportunity to perform work and are being educated in good sound construction management practices.

How does the contractor benefit? The opportunity to perform work the contractor might otherwise have been precluded from performing is obvious. Without the ability to acquire a bonding line of credit, many viable contractors are shut out from the market. They cannot get the work to build a track record and working capital.

Disbursement control does not require a requalification process. It allows the contractor to go to a bonding company, to an owner or a general contractor with increased assurances that contract funds will not be diverted or squandered.

Contractors are also able to negotiate improved credit terms. Many new or financially marginal contractors have difficulty receiving favorable credit terms. With or without payment bonds, subcontractors and suppliers are leery. The lack of competitive credit terms ties up cash, adds to project costs, decreases efficiency through purchase and delivery delays and is a continued distraction for management.

Job cost accountability is improved. Risks and problems of lien or stop notice claims are reduced. Diversion or loss of proceeds through front loading is virtually eliminated.

The contractor has the benefit of timely project financial data and tested personnel and financial systems to track costs and project profitability.

Most importantly, the contractor can use the disbursement control agent to educate themselves in good construction management practices.

What does all this cost? The fee associated with the disbursement program is borne by the contractor. The disbursement control fee is usually a fixed percentage of the total project cost paid out over the life of the project as draw proceeds are received. Rates for disbursement control services may vary in conjunction with the nature, size and scope of any one individual project.

Costs for disbursement control typically run $\frac{3}{4}$ to 1 percent of the construction contract amount with a minimal fee for small projects under \$100,000 to \$150,000.

Opponents of disbursement control programs contend that it is too costly and might be viewed by some contractors as interfering with their standard business practices. Others contend that it will do harm to contractors who are marginally financed because they cannot divert proceeds from one job to another job that might be in a cash deficit position or to use the funds to pay for administrative and overhead expenses.

We are of the opinion that the savings to the contractor to be derived from better credit terms, reduced overhead, prompt vendor payments resulting in fewer disputes and more timely contract completions will outweigh the opponents' concerns.

Chairman MFUME. Thank you.

[Mr. Acker's statement may be found in the appendix.]

Chairman MFUME. Mr. Cruz.

TESTIMONY OF JOHN B. CRUZ, III, PRESIDENT, JOHN B. CRUZ CONSTRUCTION CO.

Mr. CRUZ. Good morning. My name is John B. Cruz, III and I am president and CEO of John B. Cruz Construction Co., Inc., of Roxbury, Massachusetts, a 100 percent owned and operated minority firm.

I appreciate the opportunity to appear before your distinguished committee to describe my experiences in trying to secure the kind of contract bond arrangements which would enable our company to grow and prosper in ways consistent with our abilities, resources, experience and the opportunities that are available.

The fact is that racism and prejudice are alive and well in America and have caused us to scale higher heights and labor with greater burdens than that of our fellow majority contractors.

I would like to preface my remarks by telling you a bit about myself and the John B. Cruz Construction Co.

My father founded this firm in 1948 as a carpentry subcontracting firm. We have been in operation continuously for over 45 years. As a general contracting firm we have been in operation for over 25 years.

My father, who at 74 years old is still actively involved, working 10 to 12 hours a day, together we operate the firm. We have been able to realize annual receipts as high as \$20 million a few years back and have completed single projects as large as \$15 million.

We specialize in general contracting. We have constructed various projects such as building a runway for a United States Air Force base, a 17-story elderly housing development, a 43,000 square foot plant for the Digital Equipment Corp. and, in addition, have worked for various corporations and universities such as IBM, Harvard University, Polaroid, Raytheon, Osco Drugs, Star Market, Boston College, and Simmons College.

We, along with our minority subcontractors, create jobs, primarily for minority workers who live in the community. We have a rather significant impact on the economy of the minority community and, indeed, on the economy of the Greater Boston area.

Let me please give you an example. Presently, we employ approximately 40 employees. Ninety percent are people of color. Our employment has reached over 80 employees.

During a recent 5-year period before the downturn of the New England economy we, as a general contracting firm, contracted out approximately \$30 million to minority and female-owned subcontracting firms. Over that same period we have completed 350 construction jobs and approximately 70 percent of those employees in slots were minority workers.

During this same 5-year period the payroll for minority workers employed by the Cruz Co., and those employed by our subcontractors totaled \$25 million.

Additionally, we employed the services of minority professional firms like architects, lawyers, accounts, and various consultants. The expenditure for these services was approximately \$2 million.

Presently, we have \$8 million in contracts. Over 70 percent of those dollars are contracted with minority and female firms. Over 70 percent of the workers employed on these projects are minorities.

I have served as president of the National Association of Minority Contractors. I continue to serve as a member of NAMC's board of directors. I donate my time, money and energy to NAMC and other minority business groups because I believe very strongly that it is extremely important for the entrepreneurial spirit and traditions to be expanded in our minority communities.

I believe that business opportunities must be greatly improved for minorities and I would like to do my part to help other minority businessmen and women. Just as my father passed certain traditions and resources to me, I would like to help my fellow minority business enterprises to attain a solid foundation and means to spread true entrepreneurship throughout our communities.

My firm's experiences with bonding and my involvement with NAMC and other minority associations have given me both a personal and comprehensive sense of the problems faced by minority contractors.

By way of summary, minority contractors find it significantly more difficult to obtain adequate bonding arrangements under reasonable conditions than nonminority contractors. Minority contractors face more obstacles in obtaining initial bonds and in obtaining adequate bonding capacities. Moreover, minority contractors are more like to face demands for higher rates, inappropriate collateral and unnecessary escrow accounts. These problems are not diminishing. Indeed they are growing.

Let me tell you about my firm's experiences with bonding over the last 25 years. Our first attempt to secure a bond was in 1969. The contract value was \$60,000. After several refusals, we finally found a company willing to place the bond. However, besides the usual personal guarantees and indemnifications also my father had to place his personal savings into a bonding account that the bonding company controlled.

This was over the usual 10 percent earning requirements that bonding companies apply to auditing firms. To us this was the case of overreaching and double-dipping. We were, however, fortunate and thankful for the opportunity to receive our first bond.

After completing the project we were able to secure an additional bond for \$130,000. After that project's successful completion we were given the opportunity to construct a \$700,000 housing project. We tried unsuccessfully to find a company to bond us. After several rejections and an enormous amount of time, we were forced to look for other alternatives. We were fortunately able to obtain a letter of credit for 10 percent of the value of the project which the funding agency accepted, in lieu of the bond. The project was completed on time and within budget. We went on to complete another project for \$1 million with this same letter of credit alternative because of our inability also to obtain a bond.

After completion of those two projects, using letters of credit in lieu of bonds, our firm received a contract to build a Star Market/Osco Drugs shopping center. This complex, an approximately 1,000 square foot facility, was our largest to date. It was approximately \$1,500,000. This, too, was completed on time and within budget. We received enormous positive press for the construction of this project. It was Star Market's/Osco's first project in the black community and the newspapers and television stations also gave positive editorials regarding the shopping center and the minority construction firm that built it.

We then began to make some inroads in our attempt to penetrate the bonding area. Based on the profits from our previous project, coincidentally, the ones we were not able to secure a bond for, and along with our increased name recognition and experience, we were finally able to bond our next project, a \$1 million health center. We were able to secure the bond and also a \$3 million bonding line.

At this point we felt we were prepared to grow and become competitive, that is until we faced our next problem with the bonding company. This was as a result of a \$2 million city of Boston project which we requested and received permission to bid. But much to our dismay a couple of weeks into the bid process we received a call saying that our bonding company had reevaluated our capacity and denied the bond. Naturally we had to change our bonding agent and our bonding company. By the way, during this same period a remark was brought to my attention which a senior bond underwriter made with regard to our firm.

The remark was, "The only success Cruz has had was where some white guy was leading them by the nose." How many times are we judged by these racist and inflammable statements rather than our capacity. This person is still in the bond business today. As usual, we go through whatever obstacles we face.

With our new agent we received a tremendous opportunity. A minority community group wanted us to be the general contractor for their \$4 million project. This was in 1978. Our bonding capacity was approximately \$3 million. We received help through an innovative program run by an agency called Minority Contractors Assistance Program, MCAP, a program funded by the Ford Foundation and various surety companies. MCAP's assistance to us was in the form of providing a \$100,000 letter of credit that can be drawn in and used to finish the project in case we defaulted. This additional letter of credit helped us secure the \$4 million bond needed. The project was finished on time, but unfortunately the owner was disputing \$300,000 worth of change orders.

Additionally, a subcontractor of ours filed bankruptcy during that construction period. He was bonded and we filed a claim against his bond.

At this time we also had a contract with Harvard University for \$700,000 which turned out to be a problem project for us and we lost money on this particular project. Well, instead of working with us so we could secure additional work until our claims were settled and we worked out our problems, the bonding company uncereemoniously dumped us, shut us off, period. We were not even able to secure a revised bonding amount until our claims were settled and

our working capital was replenished. Not even at 50 percent of our previous capacity or one-third of our previous capacity, the answer was still no, nothing, zippo. It was the kiss of death similar to having the plague.

How could a black-owned construction company that was just dropped by a major bonding company find another bonding company with that stigma attached to our company. The surety industry is a very tight group. We found ourselves again with no bonding in the standard surety markets.

Personally, I swore I would have the satisfaction of writing the bonding company showing them that they were wrong and we would prevail in our efforts to secure our change orders, which, thank God, I later did.

Later, we were in the 8(a) Program and we were able to secure contracts and bond them under the personal surety regulations. These contracts, even though smaller than we previously completed, helped keep the company afloat. During this time the digital corporation decided to build a manufacturing plant in the community. We were picked to build it for them, a \$2.34-million project. Significantly, there were no bonding requirements. There was a contract to build the \$3 million housing development for the State Housing Financing Agency. Again, we were able to use a letter of credit in lieu of a bond which was acceptable to the agency. Both of the projects were completed successfully on time and within budget.

If it were not for these examples that I have given of projects we were able to secure without a bond which provided work for the company during those 2-plus years, the time needed to resolve the change order disputes and subcontractor's claims, which were resolved in our favor, we would have been out of business or reduced to the level of when we first started out as a general contracting firm.

The important fact of this issue here is for 3 years we were unable to obtain surety through the standard bond market. Yet through alternative sources we were able to secure work in order to grow and prosper. The profits derived from these projects were instrumental in adding to the retained earnings of the company which thereby increasing our bonding line. In 1982 we reentered the market with another bonding company.

Chairman MFUME. Mr. Cruz, I am going to ask since we are operating under the 5-minute rule if you would summarize.

Mr. CRUZ. Sure. All the various alternatives to the standard bond market cost minority contractors enormous amounts of time, energy and money. But it is better than no contract at all. Almost 30 years ago just out of college I didn't think I would have to repeat to my son and daughter the adage by father drilled into me: You have to be twice as good to get half as much. Over 30 years when I was finishing high school, deciding I wanted to follow in my father's business. I searched for a mentor or a symbol of success to emulate. That company was a Massachusetts contraction company called the Perini Corp. I read whatever material I could on the firm and I found out they were a third generation, family-run business. I could see the various buildings they were constructing in and around the city and looked longingly at their name placed

high on the tower cranes above the city and promised myself that one day there would be a crane above the city with the name, Cruz.

Hopefully, our firm can be a role model and a mentor, a symbol of success that inspires the inner-city youth who won't have to look outside of his or her community or race to decide that he or she would like to be another Cruz Construction Co. I assure you Honorable Chairman, and my fellow minority contractors, that I shall continue to give my time, my energy to bring about equal surety opportunities for minority, contractors, the kind of opportunities my father would have expected at this time in history.

On behalf of my company, I ask the subcommittee to work with the National Association of Minority Contractors to improve the fairness with which bonds are considered for minority contractors. The regrettable history of discrimination in this Nation cannot be ignored. But as a pragmatic businessman, I invite the Members of this subcommittee and Congress to join me and NAMC in reducing these bond problems.

Let us enter the 21st Century with more equitable bond opportunities for all contractors. Giving honor and glory to God, I conclude my testimony. Thank you.

[Mr. Cruz' statement may be found in the appendix.]

Chairman MFUME. Thank you.

Mr. ACKER, I have a couple of questions about the program you operated. Maybe for clarification purposes you can walk me through some issues. What is the incentive, as you see it, for a contractor to use your service? How do they get to you in the first place?

Mr. ACKER. Well, they would typically be sent to us by a bonding company. The bonding company might say to the contractor we would write this bond if you would employ the services of a disbursement control agent. It is basically a vehicle to get new emerging minority contractors who might not otherwise qualify for a bond because of some financial problem, past or present, where the bonding company might say, well, we will make allowances for that if you will employ a disbursement control agent.

It is not a program that is intended to be utilized throughout the life of a contractor. It is just a program that is intended to get the contractor started in the business so he can build a track record, an experience record with the bonding company and graduate into the standard market.

Chairman MFUME. So if previous financial problems were a reason that they would be referred, let's say they didn't have previous financial problems, why would they not be referred?

Mr. ACKER. They may not have previous experience with the bonding company.

Chairman MFUME. How do you ever get a previous experience record if one of the ways you get disqualified is the fact that you don't have any experience record? I am asking very basic questions. It is kind of like I won't hire you if you don't have the experience, but you never have experience if you never get a job.

So you are saying that if there are no financial problems, if someone does not have a previous bonding experience, then that would in some instances kind of disqualify them and have them sent to you as a first resort following the real first resort.

Mr. ACKER. That could be correct.

Mr. SUGAR. Let me respond to that question. You need to have a driver's license before you can drive a car. It has been my experience in the industry that most people going into the construction business have experience as a laborer, a family-owned business, being brought up into it, so when the underwriters talk about the three C's of underwriting, character, capacity and capital, part of the capacity is the understanding of the business aspects of building a construction project, as well as the technical aspects of it. So from a surety standpoint, as I understand it, the bonding companies do want to assist upstart contractors by making sure that they have some educational process that they can rely on.

What this disbursement account has done is help emerging contractors set up their books and records so that they can understand the costs that are being incurred in the construction project. Many of the States now are having legislation that deals with trust funds and characterizing the bonds in various construction projects as trust funds and almost requiring the separate checking account so those funds can be monitored.

As we know, contractors could mingle their funds, but as long as they have independent accounting records where they establish that the funds from that project are used to pay billings on that job, then everybody is satisfied.

Chairman MFUME. Let me ask you about the three criteria, whom are you subscribing those to, character, capacity and capital?

Mr. SUGAR. Those are just words used in the surety industry to establish the requirement for underlying a contractor.

Chairman MFUME. So the surety business uses those things as they move toward a determination?

Mr. SUGAR. That is my understanding, sir.

Chairman MFUME. Capacity and capital are objective but character seems to be subjective, in my opinion. If it is a subjective criteria, doesn't it lend itself unfortunately to stereotypes or bias or fears or superstitions?

Mr. SUGAR. I think Lynn Schubert, in the paper she will present to the committee today, has defined character. In fact, we should refer to her paper on that.

Chairman MFUME. What is your opinion on that, though?

Mr. SUGAR. My experience in the industry, and it goes back some time, would be that you would not underwrite a felon who has embezzled funds. That is on public record, the character of one who is going to honor his obligations.

Chairman MFUME. I just wanted to raise it because oftentimes I am used to hearing about criteria that to some extent is subjective. I can understand looking at capacity and capital. But sometimes character lends itself to one's own personal interpretation. I would like to know if either of you can tell me who you think your program benefits. Does it benefit the small minority contractors or underwriters?

Mr. ACKER. We think it benefits the contractors most. It also benefits the surety industry in that it reduces one of the risks. The major risk in the surety bond arrangement or contract, if you want to call it that, is on the payment side, it is not on the performance side. Many people believe that the performance losses exceed the

payment losses. But that is not our experience. Too many contractors have for one reason or another diverted funds from one project to another that might be in trouble.

So when we get into a situation where we are doing investigation on a contract bond loss we find that the greatest loss the bonding company takes is on the payment side. So if there is some way to reduce that risk, you are helping both the contractor and the surety.

Chairman MFUME. I just wanted to go back to what you mentioned earlier; that is, that these companies are referred to you, if they don't meet certain bonding criteria for your consideration. What criteria do you use to decide who in fact should be on control disbursement? I guess you don't just take anybody who is offered your way.

Mr. ACKER. If they are sent to us by a bonding company, we don't have a prequalification process ourselves because we assume the underwriter has already qualified the contractor to receive the bond.

In many instances we get contractors referred to us that already have the bond program, but they want to make a step up in their program. That is probably the most common.

Chairman MFUME. So you would take anybody who is referred.

Mr. ACKER. That is referred by a surety company.

Chairman MFUME. You are a for-profit company, aren't you?

Mr. ACKER. Yes, we are.

Chairman MFUME. Does risk play a determination to whether or not you accept any company.

Mr. ACKER. We are not guaranteeing that the contractor will be successful.

Chairman MFUME. But you are absorbing some risk.

Mr. ACKER. Yes. We are insured for that risk. It is basically that we do our job well.

Mr. SUGAR. It is more of an errors and omissions type of risk that we take.

Chairman MFUME. Fee determination. I thought I heard you say in your testimony that that comes about as a percentage of the total project cost. Is that correct?

Mr. ACKER. That is correct.

Chairman MFUME. What percentage do you use?

Mr. ACKER. It runs between three-quarters of 1 percent to 1 percent, in our program. There are other providers that charge different rates. We have a minimum fee of \$1,500. The reason for the scale is that some of our clients — well, the surety companies in some instances want us to make job site visits. In other instances they do not. They want us just to act as an escrow agent. That is the difference in the fee schedule.

The fee schedule even gets less when you get up above a million-and-a-half job. Then it drops down to about half a percent. We found in our investigation of the industry that $\frac{3}{4}$ to 1 percent are typically the normal fees.

Chairman MFUME. How long have you been in business?

Mr. ACKER. I have been in this business since 1988.

Chairman MFUME. Are there many or a few companies left nationwide? We had some difficulty locating disbursement control companies. I think we had only found two others. Do you know?

Mr. ACKER. We know of many. We know of at least five or six in the Dallas-Fort Worth area where we operate. We had a newsletter article out about 1 year ago. Since that time almost all our competitors in the industry have announced that they are in the same business. So we know of a number of people who have announced to be disbursement control providers.

Chairman MFUME. Congresswoman Roybal-Allard.

Ms. ROYBAL-ALLARD. Thank you, Mr. Chairman. My question is about the criteria. Mr. Acker, are you saying that if a person is turned out based on character, for example, that then you are willing to take that person on simply because the surety company referred them to you even though the surety company sees their character as questionable?

Mr. ACKER. We would not be involved in that process at all. We have no knowledge of what criteria the surety underwriter is using to qualify or disqualify the contractor. The contractor is referred to us. The bonding agent may call and say a surety company is willing to write this bond if the contractor will agree to enter into a contract with a disbursement control agent. We are not a party to the criteria that is used to determine whether that individual gets the bond or does not.

Ms. ROYBAL-ALLARD. You are helping someone, when you have no idea what the problem is. You don't know whether it is capacity or whether it is a capital problem. You are simply helping someone without any knowledge as to what the problem is as far as the surety company is concerned. Is that correct?

Mr. ACKER. Yes.

Ms. ROYBAL-ALLARD. How do you go about helping someone without having any knowledge as to what the problem is?

Mr. ACKER. Because the only service we are providing is to take control of the contract funds off the project and disburse those funds to the vendor that the contractor certifies are supplying services or products to that project.

Ms. ROYBAL-ALLARD. Let me ask you what your relationship is to the surety company. Do you advertise? Are you on a list that includes other companies that perform the same services? Do you give them a percentage? Do you pay them for the referral, for example?

Mr. ACKER. The answer to the last question is, no. We are on a list, on a number of bonding companies' lists of approved disbursement control providers. Even in the marketing of our product, our services, we do not want to be the exclusive disbursement control provider for any surety company. We are just one of a number of people out there qualified to perform the services.

Ms. ROYBAL-ALLARD. How do you qualify for being on this list?

Mr. ACKER. Both Michael and myself have been in this industry for a number of years. We have provided service to the surety industry on the claims side, doing surety investigations. We are ex-contractors ourselves. We have an understanding of the contracting business. It has been a number of years developing this program through our knowledge of surety claims and what causes surety

claims. We have been working with bonding companies to convince them there has to be a better way to reduce the risk.

Ms. ROYBAL-ALLARD. If I wanted to start a business in disbursement control and I set up the business, then could I just call and say I am now doing business. Please add me to your list, or would someone come to look at my operation, my experience and my ability to perform the services that I am saying I am capable of doing?

Mr. ACKER. Undoubtedly, they would investigate your capabilities to provide services. I am saying we have been providing services to the surety industry for a number of years. It has been more in the capacity of monitoring a surety's funds when they finance a contractor. They know our capabilities in construction management. They know our integrity in handling huge sums of money in trust situations. I would think the surety industry would look at anybody who was advertising that they were in this business that they had the same capabilities.

Ms. ROYBAL-ALLARD. There is no requirement for me to do that. I could call and they could add me to the list.

Mr. ACKER. That is certainly a possibility. It apparently is what is happening with some of the large accounting firms.

Chairman MFUME. Can you tell me who regulates businesses such as yours?

Mr. ACKER. There are some States that regulate trust agents. We don't characterize these as trust accounts. We don't physically set up a trust account. The account is set out in the name of the contractor using the contractor's ID number.

The funds are theoretically held in trust to the benefit of the subs and suppliers. There are some States that regulate our industry, but because the industry is in its infancy, we are sure that there will be some regulations imposed when it is a widely accepted practice.

Chairman MFUME. But it is fair to assume that there is no regulation of the industry that you are in whatsoever?

Mr. ACKER. Not in every State. There is some regulation in California that we know of.

Chairman MFUME. Would that be the only State that you are aware of?

Mr. ACKER. That is the only State that we are aware of.

Chairman MFUME. What would be the average profile of a contractor that you take into your program?

Mr. ACKER. At this point in time, it would probably be a small contractor.

Chairman MFUME. Yes.

Mr. ACKER. Some are minority, some are not. They have a considerable amount of experience in the construction industry. They have gotten themselves in previous trouble and the surety company wants the assurance that—

Chairman MFUME. But some have not. They probably did not have trouble; they just didn't have experience.

Mr. ACKER. In some instances they wanted to move up a notch. They had been doing \$500,000 jobs and they wanted to move up to \$1 million or \$1.5 million jobs. The surety company would basically say, if you will do this job under this program, we will write the

bond. It may be a one-shot deal. It may be a couple of jobs at that level and then they would be back in the standard market.

Chairman MFUME. Has there ever been an incident where one of your contractors either went bankrupt or had financial problems while you were providing the services to them.

Mr. ACKER. We have one in that circumstance now.

Chairman MFUME. So that is the exception, not the rule in any case.

Mr. ACKER. That is an exception.

Chairman MFUME. To be part of the control disbursement program the contractor has to assign the receivables of an account to the control of disbursement providers, in this case you and your company.

Mr. ACKER. That is correct.

Chairman MFUME. Does that cause a problem when the company then goes out and tries to pursue typical bank financing, because the receivables would be collateral.

Mr. ACKER. The problem with that is that on a bonded project the bank taking receivables as collateral is a problem because the bank does not have first rights to those receivables anyway; the bonding company does. That is kind of a Catch-22 situation. It could create problems, but we have found that the banks themselves are comfortable with the arrangement because they know the contract funds are not going to be diverted to the sources they should be paid to.

The only problem we really discovered with banks is that we ask — we almost insist that this account be established in the bank other than the bank the contractor is doing business with because of the offset provisions. If they won't waive on offsets we say the bank account has to be outside of your banking connections.

Chairman MFUME. Mr. Cruz, what is your assessment of a company that requires this kind of services? Would that have helped you in your situation before?

Mr. CRUZ. It is better than no contract at all, but I think it is unfortunately being pressed as a panacea. I see it as the minority contractor basically losing all control of the job, his or her particular profession other than the technical part of performing it on the job, whatever skill that is, plumber, electrician, whatever.

To me, I would protect a problem for them taking the next step, going to a standard bonding market when you really have not had the experience in your office growing as a normal construction person grows. I see it as better than nothing at all, but I see it as a potential problem. I could see it as creating a pool where minority contractors would sort of be lumped in this pool and found it very hard to then get out of another stigma we have been placed into.

Chairman MFUME. Has it been your experience that surety underwriters put in writing the reasons for rejection?

Mr. CRUZ. No. It has been my experience that they have not put it in writing.

Chairman MFUME. Are you asking them, though, or is it just verbal?

Mr. CRUZ. After a recent seminar, if it happens again I will ask them. Unfortunately, in the past I did not press that sufficiently.

Chairman MFUME. In your testimony you mentioned problems you thought seemed to be rather redundant or certainly growing as a result of the fact that you were a minority businessman. I will ask you to be more specific and perhaps tell the subcommittee in your own estimation to what extent you think your minority status exacerbated your problems and to what extent those problems may have been driven by someone else.

Mr. CRUZ. You talk about the three C's, character, capacity and capital. To me, all of those have been used subjectively when it comes to minority firms. Character, definitely; capacity, definitely. There is too much subjectivity in the capital rules. Somebody may have a 10 percent capital requirement and somebody else at a 20 percent capital requirement. Again, all three of those are somewhat subjective.

I have found when you are a minority firm you are subjected to tighter scrutiny than the average majority firm. Again, when you come to the escrow collateralized, we happen to be in that program now because of some financial problems. So, it allowed us to be in business, but it surely doesn't allow you to be competitive.

This gentleman has some fees I never heard of. The fees in the cases that I know of are far greater than the fees you would pay in the standard market.

Again, you run into problems with your bank because they feel like they are losing control. You are not really building relationships with the bank. In effect, the minority contractor isn't really — they are doing the on-site labor and somebody else is running the job. So I don't see that as being conducive to growing and running a construction company as others have done it.

Chairman MFUME. We have talked about verbal as opposed to written rejection. When your company was denied the bonds, did the agent tell you the deficiencies in the project or did they say you were not given a bond?

Mr. CRUZ. Deficiency, not specifically. There were some deficiencies in adequate capacity. You don't have any more capacity. We are concerned about your staff experience in that particular work. But in my case nothing specified enough to say I can come back in 3 or 6 months and make the various improvements and then I will be on other than, of course, if you had more net returned earnings we would bond you. That is, again, sort of a carrot that is hung out there.

Chairman MFUME. Were there controlled disbursement programs out there at the time?

Mr. CRUZ. Not to my knowledge. That has been probably 4 to 5 years.

Ms. ROYBAL-ALLARD. May I ask a quick question?

Chairman MFUME. Yes, certainly.

Ms. ROYBAL-ALLARD. Mr. Acker, what percentage of your business is with minority contractors?

Mr. ACKER. Presently probably in the order of 20 percent.

Ms. ROYBAL-ALLARD. Thank you.

Chairman MFUME. We have been joined by the gentlewoman from New York, Mrs. Velazquez. Do you have any questions for this panel?

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Not at this point.

Chairman MFUME. Let me thank you gentlemen for your time and patience with the committee. There may, in fact, be additional questions based on your testimony from Members who are not present. We are keeping the record open for another 5 days in that regard. If that is the case, the subcommittee clearly will get those to you in hopes of getting a response. Thank you very much for being with us this morning.

The committee would like to call a Member who has legislation pending on this matter. We are very happy to have you here and ask that you proceed in any way you see fit.

TESTIMONY OF HON. ELEANOR HOLMES NORTON, A DELEGATE IN CONGRESS FROM THE DISTRICT OF COLUMBIA

Ms. NORTON. Thank you, Mr. Chairman. I call you Chairman in two regards and I am pleased to do so.

I appreciate your unfailing work, Mr. Chairman, to promote economic equality for all Americans and especially economic equity for all Americans that seems to help discrimination in surety bonding, a deep-rooted impediment to equality for people of color, women and many other Americans as well.

I also very much appreciate your cosponsorship of H.R. 1464, the Equal Surety Bond Opportunity Act, the bill I first introduced last year and have now reintroduced to help create more minority bond insurances for minority and women-owned business.

Today, Senator Paul Simon and Senator Carol Moseley-Braun are reintroducing H.R. 1464 in the Senate. Last session Senator Simon introduced a companion bill to the one I introduced in the House. Last fall I had the opportunity to testify on the issue of access to surety bonding before Senator Simon's Judiciary Subcommittee on the Constitution. In fact, last session we did enact one of my surety bills that I will discuss presently and with the further impetus provided by your hearing today, Mr. Chairman, I believe we can get H.R. 1464 passed in the House this session.

One of the most frequent and continuous barriers to equal economic opportunity has been the financial requirement shrouded in technical mystique and it has been this financial requirement shrouded in technical mystique that is not well understood by the public.

Surety bonding is required to bid on all construction projects that cost in excess of \$25,000, all federally assisted construction projects in excess of \$100,000 and most other public construction, State as well as local.

Surety bonding requirements, however, are not restricted to Government contracting. Increasingly, private construction contracts also require surety bonding. As surety bonding has become a widespread requirement for competition, the inability to obtain surety bonding can cripple a construction firm, especially a small or nascent one.

The principal source of bonding is private for profit corporate surety firms. These sureties determine the bond eligibility of a contractor on the basis of underwriting standards which they do not always specify. During our research on the subject we learned that

small businesses, particularly those owned by minorities and women, often have been denied access to surety bonding.

Small businesses assert that decisions of corporate surety firms all too frequently impede their development and survival.

Through some conversations with the National Association of Minority Contractors and the Women Construction Owners and Executives we learned that both organizations have members who have encountered discrimination by individual surety agents, although the reasons the agents give for denial reflect more subtle forms of discrimination, WCOE informed us that the reasons given, not being married, being a woman or being an African-American woman, These are clearly discriminatory.

Last year Congress acknowledged the importance of this issue when it passed the Small Business Credit Crunch Act, and included legislation to study the problem of discrimination in the surety bonding field, a bill I had introduced.

Now part of Public law 102-366, the survey provision requires the General Accounting Office to conduct a comprehensive survey of business firms, especially those owned by women and minorities, to determining their experiences in obtaining surety bonding from private surety firms.

Our research shows the need for national documentation regarding the various problems small businesses encounter in obtaining surety bonds since only limited surveys have been constructed by private sector firms, associations and academic institutions.

GAO expects to provide Congress with results of its survey later this year. In any case, we don't have to wait for the results of any survey to mandate fairness in the surety bonding field where the existing surveys document discrimination clearly enough for purposes of remedial action.

The bill I introduced this session, the Equal Surety Bond Opportunity Act has an important and successful precedent. It is modeled after the Equality Credit Opportunity Act. The new act will prohibit sureties from discriminating on the basis of race, color, religion, national origin, sex, marital status, affectional orientation, or age, if the applicant has the ability to contract.

In addition, it will prohibit discrimination because an applicant in the past has obtained a bond through a special bond guarantee program designed to help small and emerging firms obtain surety bonding, or because an applicant has exercised their rights under this act.

The bill provides for civil liability for discrimination, including actual damages, equitable relief and attorneys's fees. The ESBOA also requires that surety firms electing to seek approval by the Treasury Department in order to provide bonds on Federal contracts meet more stringent requirements.

A surety or its agent will be required to notify a contractor within 20 days of receipt of a completed application for a bond of the action taken on its action for a bond.

The surety will also be required to provide contractors whose application for a bond has been rejected with a written statement of reasons for such rejection. I am told by NAMC that minority contractors seldom receive clear reasons for bond denial or the kinds

of suggestions that would help them meet reasonable underwriting standards in the future.

H.R. 1464 simply encourages fairness in existing processes. What this bill says to surety bonding firms is that if you wanted to be Treasury listed you will provide certain information when you deny a bond to an applicant. Since the Federal essentially has contracted out the preapplication screening process to private surety bonding companies, it is only reasonable and fair to ensure that the sureties are following fair procedures just as civil servants must do when reviewing, awarding and denying Federal contracts.

The disclosure of pertinent information to rejected applicants is an equitable principle familiar throughout the Federal acquisition process.

For example, when a small business is turned down for a Government contract, that business can get a negative preaward survey. Armed with this information, the business can contest the award or use the information to be better prepared for the next award competition.

The more business knows about what is wrong with its proposal, if there is something wrong with it, the greater the likelihood that the next time the business will submit a better and more competitive proposal.

H.R. 14694 will help create an environment in which qualified small business firms, particularly those owned and controlled by minorities and women, can successfully obtain adequate surety bonding. This legislation will enable us to ferret out continuing biases in the industry.

Whatever these prejudices may be, getting rid of them will open up the industry creating entrepreneurial and employment opportunities and making the business more competitive.

Mr. Chairman, your attention to the problems and access to surety bonding will help to bring us closer to the passage of H.R. 1464. I look forward to continuing to work with you and with associations that represent small minority and female contractors to reduce and eliminate barriers to economic equity for all Americans.

I thank you for the opportunity to testify here today.

[Ms. Norton's statement may be found in the appendix.]

Chairman MFUME. Mrs. Norton, we thank you very much. We recognize that you are under a number of severe time constraints so we appreciate the time that you have given to us in explaining the impact and intention of the legislation that is before the House and now we have been told is before the Senate. I would like to ask, perhaps, a basic question.

Perhaps you are the best one to answer this. I would like to know what has been the type of criticism that you received from the surety industry regarding the introduction of the bill and have they attempted in any way at all to help shape legislation or has it been an adversary or critical relationship?

Ms. NORTON. It has not been entirely adversarial yet. I don't think the industry felt the bill would move as quickly as it has with Senator Simon moving it in the Senate. I think the industry sees it difficult to think that creditors ought to be included under the Equal Credit Act and nothing regulates them. The only hearing

that has been held has been in the Senate. I am not aware of what specific criticisms they may have.

Chairman MFUME. Have they at all expressed a desire to help shape the legislation beyond what is formally contained in the bill?

Ms. NORTON. They have not to me.

Chairman MFUME. Thank you. Ms. Velazquez?

Ms. VELAZQUEZ. I have no questions.

Chairman MFUME. Mrs. Roybal-Allard is out right now. You may have not heard some of the testimony earlier regarding control disbursements and the Control Disbursement Program. Two members of our previous panel were on before the committee talking about that.

I don't know to what extent you are aware of the Control Disbursement Program, if you had any thoughts about it and to what extent you think this legislation will impact it.

Ms. NORTON. I am sorry I missed that testimony.

Chairman MFUME. We appreciate your time and effort. We certainly appreciate the news about the actions of the Senate.

We are leaving the record open for 5 days; there may be other Members who could not be here this morning who might have questions once they have the chance to read the testimony and read the bill. The subcommittee will give those to you.

Ms. NORTON. Thank you.

I hope that my staff can work with your committee staff, because I really do think that the fact that this bill has not brought the wrath of the world down on us means there is understanding that the time for surety and bonding companies has come. I think particularly with your interest, we have a very good chance to pass the bill this time.

I want to thank you very much for these hearings and for the opportunity to speak for the first time in the House of Representatives on this.

Chairman MFUME. I would like to call Mr. Wayne Ruth, president, Hunt Valley Masonry, Inc., representing American Subcontractors Association; Samuel A. Carradine, Jr., executive director, National Association of Minority Contractors; J. Martin Huber, executive director, National Association of Surety Bond Producers; and Lynn M. Schubert, assistant general counsel, American Insurance Association.

I would like to proceed in the order of first hearing from Mr. Ruth, then Mr. Huber, then Mr. Carradine, and then Ms. Schubert.

TESTIMONY OF WAYNE T. RUTH, PRESIDENT, HUNT VALLEY MASONRY, INC. REPRESENTING AMERICAN SUBCONTRACTORS ASSOCIATION

Mr. RUTH. Good morning.

Thank you for the opportunity to speak with you today. I am Wayne Ruth, president of Hunt Valley Masonry in Hunt Valley, Maryland. Today I am representing the American Subcontractors Association [ASA], a national association representing 6,500 specialty trade contractors in the construction industry and 75 chapters nationwide. The demand for surety bonds has been growing in

all sectors of the construction market, public and private, general contractor, and subcontractor.

At the same time, there is a growing body of evidence that some subcontractors, particularly small and emerging firms, have difficulty in obtaining the full amount of surety bonding for which they are qualified.

Contractors usually look to their surety agents when looking for ways to become more creditworthy. Unfortunately, according to two surveys conducted by the Foundation of ASA, specialty contractors all too frequently do not receive the level of service that is needed. The extent of the failure of the agency system to serve the needs of contractors is clearly demonstrated by the FASA survey.

For example, only 43 percent of the agents provided positive advice useful in preparing material for submission to a surety. Only 29 percent explained surety underwriting criteria in advance to submitting the contractor's case to the surety. Only 24 percent advised the contractor of underwriting changes in advance.

This lack of service is particularly deadly at a time when underwriting standards are in a state of evolution themselves. As one contractor member told me recently: "Every time I deal with my surety agent, I feel like Charlie Brown playing football with Lucy."

While ASA acknowledges there is a problem with surety bonding, we do not believe there is a single solution. Our written testimony explores a menu of options, and I am sure there are others we have not yet explored.

While we do agree with those that say that contractor education is an issue, we must question that customers are the only problem. Bill Gates would still be trying to make his first million if his principal marketing tool was complaining that his customers didn't know how to use computers.

ASA believes that the legislation of regulatory reforms are as necessary as education.

ASA strongly supports H.R. 1464, the Equal Surety Bond Opportunity Act. This bill offers the best opportunity for contractors to get the information they need to obtain the full amount of surety bonding for which they are qualified.

The bill would provide a construction contractor denied a bond during the surety prequalification process with the opportunity to make changes in the firm necessary to allow it to obtain a bond.

ASA believes that these disclosure requirements should be among the minimum standards that should be met by surety companies that elect to provide bonds on Federal contracts. We note that these proposed minimum standards parallel almost exactly the requirements imposed on providers of consumer and certain types of business credit under the Equal Credit Opportunity Act.

While ASA believes that the enactment of the Equal Surety Bond Opportunity Act would be an important first step toward addressing the surety bond access problem, we do not believe it is the only solution. In addition, we would like to suggest that Congress consider expanding the bond waiver pilot program currently in place under Section 8(a) of the Small Business Act. This allows contractors to waive bonding requirements if they use direct disbursement or as an escrow account.

The account has been effective to the extent it has been used. We believe a properly implemented escrow account or direct disbursement program would provide adequate protection for subcontractors.

In addition, ASA asks that you urge OFPP and the Department of Defense to end their foot dragging on the implementation of Policy Letter 91-4 which would allow the use of letters of credit in lieu of surety bonds. We believe this alternative provides adequate payment protection for subcontractors and suppliers.

Mr. Chairman, ASA looks forward to working with you and the subcommittee to explore the extent of barriers to qualified contractors to adequate surety bonding and to solutions to this serious problem. We believe the first step should be the enactment of H.R. 1464, the Equal Surety Bonding Act.

Thank you.

Chairman MFUME. Thank you.

[Mr. Ruth's statement may be found in the appendix.]

TESTIMONY OF J. MARTIN HUBER, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS

Chairman MFUME. Mr. Huber.

Mr. HUBER. Thank you.

I am executive vice president of the National Association of Surety Bond Producers. NASBP is an organization of some 560 agencies and brokerage firms that specialize in surety bonding and insurance for construction contractors. We also count as NASBP affiliates some 65 of the most active surety bond underwriting companies.

As you mentioned, Mr. Chairman, in your statement, most companies that underwrite and issue surety bond work through agents and brokers, also known as producers. NASBP member producers are often called upon to guide small, minority- and women-owned contractors through the bonding and prequalification process.

Contractors who are establishing their initial relationship with a surety company will find that it is necessary to spend a considerable amount of time and effort with their surety producer in assembling their first submission to a surety company.

Applying for surety credit is not the same as purchasing an insurance policy. The information the surety company wants to see in the submission is needed so that the surety underwriter can satisfy herself that contracting firm is a well-managed, profitable enterprise, which keeps promises and deals fairly, and performs obligations in a timely manner.

Each surety bond company has its own standards and requirements. The surety producer represents several surety bond companies and knows the differing underwriting standards of each of the companies he represents.

It is the producer's job to match the contractor with the surety bond company whose underwriting company best fits the particular contractor. While surety bond company's standards differ, there are fundamental kinds of information that most surety bond companies want to see in a submission from a contractor, especially a first-time submission.

We have gone into these in some detail in our written statements. There is not really time for me to do so orally, although I could answer questions, if you would like.

The point I want to make is that a knowledgeable surety producer can help small, minority and women contractors overcome the problem of weak or marginal information in one area by emphasizing strengths in another. The producer knows which of the surety companies, for example, place heavy emphasis on financial information, which may give more weight to experience and overlook some weakness in the financial area, which prefer bonding excavation contractors as opposed to building contractors and which welcome smaller contracting firms or even those with infrequent surety needs.

The contractor's surety producer will, in fact, preunderwrite the contractor and help package the contractor's submission in a way to most likely to be acceptable to a particular surety company. In short, Mr. Chairman, NASBP members take great pride in the role they play in aiding small, minority- and women-owned contractors in their growth and development.

You asked us to speak on what ways Congress can prohibit any discrimination that exists in surety bonding. There are two bills before the House of Representatives dealing with minority- and women-owned business, both of which have NASBP support.

The first is your own bill, Mr. Chairman, H.R. 278, that would upgrade the Department of Commerce's Minority Business Development Agency to the Minority Business Development Administration. NASBP fully supports this legislation, especially its goal of making management and technological assistance available to disadvantaged businesses.

Further, we stand ready to help in the establishment of a surety bond referral assistance program called for in Section 202 of this bill. As a matter of fact, we are currently working with the National Association of Minority Contractors, and Mr. Carradine, to put in place just such a proactive referral program for his association.

Mr. Chairman, our organization is unequivocally opposed to discrimination in surety bonding based on race, color, religion, national origin, marital status, sexual orientation, disability or age. We support therefore, very strongly, the provisions of Congresswoman Norton's legislation, H.R. 1464, that prohibit such discrimination.

We also support the provisions that require underwriters and producers to provide to any contractor for whom it is unwilling and unable to provide surety bonds the reasons why it will not provide such bonds.

NASBP supports this as a fundamental right. In fact, our members not only give reasons, but counsel the contractor on what changes he or she needs to make in their business practices or operations in order to qualify for surety credit.

Another thing that Congress can do to enhance the minority, women-owned business and emerging contractor access to the surety bonding market is to support the U.S. Small Business Administration's Surety Bond Guarantee Programs. While many members participate in the original prior-approval program, it is the newer, Preferred Surety Bond Guarantee Program that is of

real interest to NASBP's members and the standard surety companies that they represent.

The SBA's Assistant Administrator in charge of this program, Dorothy Kleeschulte, who I know has submitted testimony to you, Mr. Chairman, reports that fully 25 percent of the bonds that have been guaranteed in this preferred program have been written for minority contractors.

Finally, Mr. Chairman, the results of a recent survey of NASBP members indicate that the surety industry is, in fact, writing bonds for qualified minority- and woman-owned contractors. One hundred and twelve corporate surety companies were identified as actively writing bonds for small contractors. Surety bond companies were identified in every State, the District of Columbia, and Puerto Rico.

Further, the 50 percent of our members who responded to this survey successfully assisted some 7,912 small contracting firms with their surety bonding needs during the past 12 months. Thirteen percent of these 7,912 firms were minority-owned and 7 percent were women-owned. Of the 2,400 of these firms that were seeking their first ever bond, 17 percent were minority-owned and 12 percent were women-owned.

This list of 112 surety markets for small contractor bonds includes most of the major surety companies in this country, many of which have established special small contractor units to handle these efficiently. Also on the list are new companies that have entered the surety business with the goal of specifically targeting the small contractor market segment.

Mr. Chairman, NASBP's strongly held view is that the primary reason why qualified small and emerging contractors are not able to get surety bonds is that they are not utilizing an agent or a broker who specializes in surety.

There are some 40,000 independent insurance agencies in the country whose State insurance licenses allow them legally to produce surety bonds. Very few of these 40,000 are surety bond specialists.

Many of those who do specialize in bonding are members of NASBP. Through liaisons with numerous contraction industry organizations, including the National Association of Minority Contractors, the National Association of Women in Construction, the American Subcontractors Association, Women Construction Owners Executives and others, NASBP is making itself and its members known to contractors who need bonds.

NASBP member producers earn no fee unless bonds are written. Unlike the increasing numbers of surety consultants who charge a fee before they offer their advice or assistance — and whose bonding "solution" is often an unlicensed, unverifiable off-shore surety — NASBP members' incentive is to qualify the contractor for surety credit in legitimate surety companies so that bonds can be written and commissions earned. Helping small, emerging contractors grow into large, profitable firms creates the most loyal customers that a surety producer has.

NASBP members are in business for the long term, and that is clearly what they want for their contractor customers.

Thank you, Mr. Chairman, the subcommittee and the professional staff, for the opportunity to present our views on this issue.

Chairman MFUME. Thank you very much, Mr. Huber.
[Mr. Huber's statement may be found in the appendix.]

TESTIMONY OF SAMUEL A. CARRADINE, JR., EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF MINORITY CONTRACTORS

Chairman MFUME. Mr. Carradine.

Mr. CARRADINE. Good morning, Mr. Chairman and Honorable Members. My name is Samuel Carradine, and I am the executive director of the National Association of Minority Contractors, NAMC.

Established in 1969, and headquartered in Washington, DC, the National Association of Minority Contractors or NAMC, as we are called, has over 3,500 members and is a full-service association which represents the interests of the Nation's minority contractors.

On behalf of these contractors, NAMC would like to thank the subcommittee for holding this hearing and examining the issues which affect the access to surety bonding by qualified small, minority and female-owned construction firms.

Regrettably, NAMC must agree with the increasingly pervasive assertion that bonding difficulties constitute the most severe obstacle to equitable participation in public construction projects by qualified minority, small and female contractors.

Moreover, with the possible exception of the acquisition of initial bonds — usually under costly and potentially harmful arrangements — the obstacles presented by inordinate bonding difficulties are not diminishing for these contractors.

The great importance of our members' access to contract bonds has prompted NAMC to devote enormous time and effort to bonding issues. We have monitored the extent and nature of their bonding problems through a number of efforts, including: Conducting surveys; conducting research projects; noting the specific problems reported by individual contractors, and tracking the actions of surety companies and producers in responding to requests for bonds by minority contractors.

Through these efforts, we continue to find that minority contractors who are qualified to perform public projects encounter bonding problems far more frequently than nonminority contractors. These bond problems may be attributable to the following causes.

First, historical discrimination. This country's record of pervasive and persistent institutional discrimination has placed minority contractors in positions of disadvantage in capital acquisition, financing procurement, and many other areas which are related to their abilities — or in abilities — to obtain satisfactory bond arrangements. Ironically, the discrimination they face in seeking private jobs leads many minority contractors to turn to public jobs, the very jobs for which bonds are usually required.

Second, the disparate effect of surety underwriting standards. Surety underwriting standards which may not be designated to discriminate specifically against minority contractors can create larger barriers for minority contractors. For example, standards which discourage bonds for small contractors or subcontractors usually affect a greater proportion of minority contractors because

relatively large percentages of minority contractors are "small" and are subcontractors.

Third, deliberate and subconscious discrimination by parties in the surety industry. Often, a favorable final response to a request for bonding depends on positive reactions and enthusiastic advocacy actions by several parties: The producer, the local underwriter, the bond manager, and headquarters offices. A discriminatory act by any one party can easily bring about a declination.

Fourth, the inadequacy of bond assistance programs. For a variety of reasons including the lack of technical surety experience, inappropriate approaches, and ineffective implementation steps, minority contractors report that programs conducted or sponsored by public agencies often fail to improve their bonding prospects.

Fifth, lack of information. Even when bonds are denied without deliberate or subconscious discrimination, minority contractors seldom receive clear reasons for such denials nor the kinds of suggestions which would help them meet reasonable underwriting standards in the future.

The bond problems of minority contractors are not limited to being declined when requesting bonding. We have also found that minority contractors are less able to obtain advantageous bond arrangements such as bond lines of credit and effective loss-prevention services.

Minority contractors are most likely to pay higher premiums for bonds. Minority contractors are more likely to be steered to Government guarantee programs than similar nonminority firms, and these programs are usually more costly and require more time and documentation.

Minority contractors are more likely to be offered bonds with inappropriate and often potentially harmful conditions such as collateral and escrow. Minority contractors often find it more difficult to enlarge or expand their bond capacities.

As one would imagine, these conditions present huge competitive disadvantages to even the contractors who can obtain bonds.

In addition to simply studying and monitoring bonding issues, NAMC has undertaken several active steps to improve the bond prospects of minority, small and female contractors: We have held meetings with representatives of surety industry associations to identify and implement mutually acceptable actions. We provide technical surety guidance and assistance for our members, to the extent that our resources allow.

We advise State and local government bodies on effective ways to establish and operate bond assistance programs. When appropriate, we perform Government-funded projects to assist minority, small and female contractors in obtaining satisfactory bond arrangements. One such program we have worked in the past has been MBDA and we are now providing DOD in their program.

We have engaged a consultant who possesses technical expertise and experience specifically in the issues which surround bonding for minority, small and female contractors. We actively support legislative and administrative actions, at Federal, State, and local levels, which would have the effect of creating more equitable bond opportunities for minority, small and female contractors. We are

constantly exploring new methods to improve the bond prospects of our contractors.

We would respectfully ask this subcommittee, and indeed the Congress, to support equal opportunity and fair play for the acquisition of bonding for Federal construction contracts. At the present time, we would like to make the following specific recommendations.

One, we urge quick passage of the Equal Surety Bond Opportunity Act. We strongly support both the salient provisions of this act: That discrimination by race, color, religion, national origin, sex, marital status, sexual orientation, disability or age be prohibited on considering Miller Act bonds; and that contractors be notified of the reasons for adverse actions taken on bond requests for Federal jobs. When bonds are required for Federal jobs, minority contractors should be assured that their bond applications will be considered without the kind of discrimination that has been prohibited by law in many other areas of business activities.

Two, we request a review of the Miller Act threshold which now stands at \$25,000. Inflation has greatly increased the number of small Federal jobs which now exceed the threshold. We have two concerns here: Minority, small and female contractors are the ones most likely to seek very small Federal jobs; but these contractors encounter the heaviest obstacles in obtaining bonds. In this time of great budget concerns, it appears wasteful to spend tens of millions of Federal dollars to bond the kind of very small jobs that the Congress intended to exclude by increasing the threshold to \$25,000.

Three, we ask the subcommittee's help in providing more effective technical bonding assistance for minority, small and female contractors. For instance, we believe the Minority Business Development Agency has the potential to help provide such assistance.

As part of a surety project we conducted last year, we gave MBDA detailed advice and recommendations on how to provide effective bond assistance, but to date, MBDA has not provided bond assistance of any consequence.

In addition, active implementation of a variety of existing laws and regulations would permit several Federal agencies to help provide bond assistance.

Four, finally we ask the subcommittee to work with us and with other associations which represent small and female contractors to fashion legislative initiatives which are appropriate to reduce the severe, numerous and persistent bond problems our members face.

This concludes my prepared statement. I would be pleased to respond to any questions you might have.

Chairman MFUME. Thank you very much.

Chairman MFUME. Ms. Schubert.

TESTIMONY OF LYNN M. SCHUBERT, ASSISTANT GENERAL COUNSEL, AMERICAN INSURANCE ASSOCIATION

Ms. SCHUBERT. Thank you, Mr. Chairman.

My name is Lynn Schubert. I am Assistant General Counsel with the American Insurance Association. AIA is a trade association of major property casualty insurers, including most of the largest writers of surety bonds for Federal construction projects.

AIA would like to thank the Chairman for convening this hearing and for inviting us to testify on the important topic of the development of small and minority construction contractors through access to the surety bond market.

In this testimony we will address the request in your letter to guide you through the underwriting process, including communications with applicants. We also will address how the surety industry has responded to the need to improve access to surety bonds for small and minority contractors, and the AIA position on H.R. 278 and H.R. 1464.

Surety bonds are an integral part of the process of Federal construction, and as such, it is vital that all qualified contractors have equal opportunity to obtain these bonds.

AIA is committed to the concept of nondiscrimination in surety bonding on the basis of race, color, religion, national origin, gender, marital status, sexual orientation, disability or age. Surety bonds, like all other products, must be available to all qualified contractors on an equal basis.

There are, however, legitimate bases on which to determine whether or not a contractor is qualified to obtain a surety bond. A surety bond is not like a traditional insurance policy such as an automobile policy.

A surety bond is not a right to which every contractor, despite his or her experience, financial strength, or character, automatically is entitled. Neither is it a right for every contractor to be awarded a Federal construction contract, regardless of the contractor's ability to perform the work.

Underwriting a surety bond. One of the best explanations of underwriting a surety bond appears in the newly published "The Law of Suretyship," which the America Bar Association published this year.

Rather than go through all the details, I have requested permission from the ABA and also from the author of that chapter, Stewart Duke, of the Fidelity and Deposit Company, to attach that as an attachment to our written testimony, which I have done.

You will notice that chapter written by Mr. Duke does not talk anywhere about the old traditional concept of the three "C's." It talks about the specifics of what is required in underwriting a surety bond.

The industry has moved a long way from its actions of thousands of years ago when the surety bond was first started and it really has made an attempt to deal on an objective basis, although there will always be some subjectivity in any kind of a credit process.

Our written testimony does summarize the important steps of underwriting. I will try to just mention some of the highlights today in this verbal statement.

Mr. Chairman, you already have done an excellent job in describing what surety bonds actually are. As you said, the first step in getting a surety bond is finding a surety bond producer.

You have had heard from Mr. Huber on that subject, and I will not repeat all of those provisions here, although we do describe some of the importance of the surety bond producer in our written statement.

Once the producer has completed the initial evaluation of the contractor's information and prepared the application package, the package is then submitted to a branch office underwriter for review. The first thing the underwriter will want to do is familiarize himself or herself with the contractor and the contractor's business. This usually requires a new account form.

This form gives a basic overview of the construction company. The information on this form includes how long the contractor has been in business, the owners of the business, the type of work performed by the contractor, examples of previous projects, method of reporting financial information, tax information, a summary of the company continuity plan, bank lines of credit, whether or not the contractor bonds its subcontractors, and previous surety relationships.

The underwriter also will need resumes of key company employees and owners, a listing of prior bids of the company and who prepared the bids, the results of those bids, and the profits on projects awarded. The continuity plan of the contractor is important to the surety, since many projects are of long duration.

If a major owner of the company dies during the term of the project, it is critical to know that the company will be able to continue in existence to complete the project, or fulfill its duty to reimburse the surety if the surety is required to complete the project on its behalf.

The surety will want to review prior tax forms of the company, as well as at least three prior year-end fiscal statements.

The contractor's method of accounting and financial records are of primary importance to the surety underwriter.

The surety also will review the credit record of the contractor to determine if the contractor pays its debts on time.

Lastly, often contacts made to owners and architects on prior projects of the contractor.

Once all of this information is reviewed by the branch office underwriter, the submission normally is submitted to the home office.

Often the home office underwriter likely is either an attorney or CPA, or in worst-case scenario, both. As you can imagine, the underwriter is likely to have questions for the contractor.

These questions are relayed to the contractor and hopefully additional information is submitted to satisfy the concerns of the underwriter. Once this takes place, and the surety is comfortable with the contractor as a potential client, the surety examines the contract documents for the specific job being bid.

While this may seem excessive, contract documents contain a myriad of clauses which can defeat the unwary contractor. If a contractor is bidding for public work for the first time particularly, the surety can assist the contractor by pointing out particularly onerous clauses such as a clause often put in contracts requiring the contractor to indemnify the owner for the owner's sole negligence. Once both the contractor and the surety are comfortable with the contract documents, then a bond is written.

If the decision rather is made not to write the bond it is our understanding that all of AIA members, as well as the Surety Association of America members, which are over 600 surety companies, give reasons for declining that bond application.

Those reasons are then either transmitted directly from the underwriter or through the bond producer to the contractor.

Here today, we have heard a number of times the statement made that clear reasons are not given to the contractor. I think perhaps the concern and the problem that we are having is a definition of what is "clear." It is important that the reasons that are given to the contractor enable that contractor to make whatever changes are necessary to participate in the surety bond market.

We will continue to request our companies to make a better definition of their reasons and the producers, I know, have committed to do the same thing. We will continue to work with contractors on that issue.

As you can tell from the length of the description that I have gone through, and this is just the highlights of the process, this is a lengthy process. Underwriting is not an easy thing. It is not easy to complete all the information. It cannot be done in just a few days.

Once a surety/contractor relationship is established, the surety will require the contractor to continue to submit current information to keep the file on that contractor up to date. As long as the contractor's file is up to date, the time within which a decision can be made on each particular bond request certainly is reduced. But the first-time bond applicant will certainly have a longer response period than an ongoing contractor/surety relationship applicant.

The surety underwriting process is different for each company. The National Association of Minority Contractors last year did a survey of underwriters to determine just what the underwriting criteria are, looking for the specifics.

As a trade association, due to antitrust concerns, we do not get into the specific underwriting requirements of each company. However, the companies did respond admirably to the survey and I understand that NAMC does have a great deal of information on this which they are now able to provide to their members, to know which companies are targeting which type of contractor and what kind of information is being required from each company.

One thing that most companies do have in common, however, and it is important to recognize that this is true for all contractors, is the requirement of personal indemnity. A standard surety company normally will require the personal indemnity of not only the contractor-owner, but oftentimes the spouse, whether it is a woman-owned contractor and they require the husband, or if it is a male-owned contractor and they require the wife, they are going to require the spouse in either instance, as well as any children and spouses which are involved in the business.

Not only does this extra, I guess, comfort, encourage sureties to write new contractors, it often increases the size of the bond the surety is willing to write without that kind of personal indemnity.

Things such as collateral and the direct disbursement program you heard about earlier from Mr. Acker and Mr. Sugar are other things that can play into the process of increasing the bond amount available or perhaps getting a bond for a new contractor.

Those are programs that once a contractor gets a surety bond, should be phased out. That should not be a long-term process for a contractor, because they do affect the contractor. They do make you a little less competitive.

You don't want to keep collateral with a surety for your entire business career. You want to post collateral, get your first bond, establish a record with that surety and then get your collateral released back to you as a contractor.

The most important thing to remember about surety underwriting is that it takes a commitment on the part of the contractor to keep comprehensive, up-to-date financial and business records, and to keep the surety informed of all pertinent information. It is not an easy process to be a bonded contractor, but the protection the surety provides to the taxpayer and subcontractors on that job justifies this comprehensive approach.

I would like to briefly address some of the other questions that you raised such as our industry action to increase bond availability. I think Mr. Huber has really described that very well, the number of companies that have established companies to specifically target small, and new and emerging contractors.

I won't go through his survey results for you. But I would like to highlight some of the Government programs that we have also been a part of. Most important, I guess, is the SBA Surety Bond Guarantee Program that has been described to you today.

Plan B, which was instituted in 1988, I believe, and finally got up and running after all the process of getting the regulations written and getting the regulations published in the Federal Register, has been an extremely successful program in writing bonds for new, small, and minority and women-owned contractors. Many of the participating companies are targeting strictly those companies for their Plan B business.

As of May 30, 1993, for fiscal year 1992-1993, this program allowed almost a billion dollars of contracting opportunity for participating contractors. Sureties provided 4,411 bid bonds during this time through Plan B. As of July 14, 1993, 685 of those contracts were awarded to the participating small businesses, and final bonds were written for a total of \$145,309,211 in contract value. These are bonds that normally would not have been written for these contractors and the sureties are making an effort to do that.

The concept behind this program and the thing that we think is most important about it, is that it is an up-and-out program. It is not a program where contractors are going to be stuck in Plan B, and are going to have this additional cost of participating in a bond guarantee program. The concept of bringing these standard sureties into the SBA Program is to give new contractors an opportunity to get a bond where they wouldn't have gotten a bond before, establish a track record, and then these companies that have good traditional programs are moving those contractors out into their standard programs and bringing in new and different contractors through the guarantee program. That is why we are so enthusiastic about it.

We think it is critical that the industry and the contractors continue to support the SBA in this process.

Chairman MFUME. Ms. Schubert, for the sake of time, I will ask you to begin to summarize.

Ms. SCHUBERT. Yes, sir. I just have a few more things.

Let me point out to you that the U.S. Department of Transportation also has a program for minority contractors, as does the

MBDA. In addition to this, there are a lot of State programs that we have supported in every State to increase availability for bonds.

Further, you have heard that the Surety Association, NASBP and AIA have been working with other trade associations, including ASA and NAMC, for a number of years. We instituted a program to notify all Federal agencies, State insurance departments, ASA, AGC, NAMC, and a number of other organizations that if any contractor lets them know that they have been unable to get a bond, and they believe that it has been for a discriminatory purpose, that we will have our members review that information, review that contractor's submission, and attempt to either get a bond for that contractor or give them a written reason why not and what would be necessary to get a bond.

We think that is critical for the Chairman to know that the industry is voluntarily working to try and eradicate the concerns and the perceptions that are out there.

One idea that we think is ripe for implementation is a program both Mr. Huber and Mr. Carradine discussed, to assist small-, minority-, and women-owned contractors in learning how to get bonds. We believe H.R. 278 is the perfect vehicle to implement such a program.

We have supported that since its introduction. We also have supported Delegate Norton's bill, the Equal Surety Opportunity Act. We supported the study bill last year. We testified before Senator Simon last year that we supported the study bill.

We looking forward to the results of that study. We will continue to support the Equal Surety Bond Opportunity Act. Although I have to tell you that we do have some concerns about the technical provisions. We have met with staff for Ms. Norton, both last year and this year.

I noticed when you asked her that question, whether we had been trying to work on changing the provisions of the bill. While she responded no, her staff was frantically writing her a note over on the side. So, perhaps a follow-up question might be in order, because we are working very closely with her staff on those bills.

We just want to reiterate that this is an important issue to us. We do not discriminate and we do not intend to discriminate. It is a critical issue to our country and if there is anything the surety bond industry can do to eradicate any perception of discrimination, we are here to work with you on that.

[Mr. Schubert's statement may be found in the appendix.]

Chairman MFUME. Thank you very much.

My thanks to all of you.

The Chair, exercising its own prerogative, is going to first yield to Ms. Velazquez who has been very patient. The Chair has had an abundant opportunity to ask questions and I have been doing that.

I yield to the gentlewoman from New York, Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

I would like to ask my first question of Mr. Huber.

What if one of your clients, a minority female contractor, comes to you and tells you that she has been denied a contract, even though she has been following the guidelines, and you believe she will definitely receive a surety bond. How would your organization assist this contractor?

Mr. HUBER. We would determine who the agent or broker was that the contractor was dealing with and we would refer that contractor to one of our members to review the submission to determine if there really was an unwarranted kind of discrimination involved, to determine if the contractor would qualify for some surety company's standards.

If not, the agent would explain to the contractor what was lacking and what they had to do and what changes they had to make to qualify for surety credit.

Ms. VELAZQUEZ. Mr. Carradine, you mentioned in your testimony on page 4, that minority contractors do not receive a written denial. Do you have any knowledge if nonminority contractors receive a clear written denial reason?

Mr. CARRADINE. I don't think they are clear, precise and uniform procedures for explaining either acceptance or rejection of a bonding generally.

Ms. VELAZQUEZ. You strongly feel that this is very important?

Mr. CARRADINE. Yes, in fact, one of my staff persons has drafted a uniform rejection form that we are trying to get the industry to utilize.

Ms. VELAZQUEZ. Do you have any statistics on the numbers of the contractors of all races who receive bonds?

Mr. CARRADINE. In general, no, I don't right here?

Ms. VELAZQUEZ. Mr. Ruth?

Mr. RUTH. No, ma'am, I do not have that statistic.

Ms. SCHUBERT. We may be able to get that statistic through OFBP for Federal procurement.

Ms. VELAZQUEZ. Will they be broken down?

Ms. SCHUBERT. They are beginning to keep those records. The SBA keeps its record broken down on the bond guarantee program and you may be able to get some information there.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Chairman MFUME. Thank you, Ms. Velazquez.

Ms. Schubert, I have a couple of questions here.

I want to be very specific about this. Typically, at first blush, should an agent or producer be able to determine if a contractor is, in fact, bondable by the explicit criteria that is used and what is the time frame between when it is determined that a company is not bondable and the time something is, in fact, put in writing to that effect?

Ms. SCHUBERT. The first question is who the agent and the producer is. If you are talking about somebody who specializes in surety bonds, they will be able to determine if the companies that they have had licenses with will be able to bond that contractor. If you are talking about somebody who might just have a surety bond license but really specializes in automobile or homeowners insurance, they, on the other hand, may not be able to determine whether that contractor is bondable or not.

If you have a specializing agent, they should be able to know generally what is necessary from the underwriter's standpoint and they will submit that. If a decision is made not to write the bond, the reason should be able to be written and given to that contractor within a couple of days. That is not the problem.

Chairman MFUME. Is it typical?

Ms. SCHUBERT. My understanding is that is fairly typical. Maybe Mr. Huber can explain that or clarify that. But the concern is the time from the initial application, the person walking in the office and saying I need a surety bond, to when that decision actually can be made, whether the contractor is bondable or not. Because so much information has to be gathered; so many pieces of paper have to be submitted.

If you have it all put together very well the first time and submitted, you can get a response fairly quickly. If it comes in dribs and drabs, every time you have to go back to the contractor to request additional information and they have to go back to their CPA to get additional paper, it extends the decisionmaking time.

Chairman MFUME. You suggested that your association works with contractors to give them an idea of what they need to do to become bondable? Did I hear you say that?

Ms. SCHUBERT. Our members work through the producers. We, as an association, have worked closely with contractor associations. We work with AGC and the NAMC. So from an association standpoint, we try to get that information together.

Also, our members did respond to Mr. Carradine's survey, who can give that information to the contractors.

Chairman MFUME. Who was involved in the initial approval process? In other words, is it a collective decision, is it singular?

Ms. SCHUBERT. It would depend very much on several factors, how the company does it. Each company has underwriting authority of a different dollar amount that they give to their branch offices. Perhaps, depending on the experience of the underwriters within the branch office, it may even vary from branch office to branch office.

If you need a small bond, say, \$25,000, or even a \$10,000 bond, you may find a branch office underwriter who can even write a new account right out of that office. If you have to go to a \$100,000 bond, which is much more substantial bond, then you probably need to probably send it to the home office. In that instance, you have the home office underwriter. If you need \$1 million bond, you probably have to go to the home office supervisor.

Chairman MFUME. So, the higher the bond, the more people are involved in the approval process?

Ms. SCHUBERT. I think that is probably accurate in most companies.

Chairman MFUME. Would you say also with the larger number of people involved in the approval process then the approval or disapproval is much more objective in terms of its criteria and in terms of the way it is applied, I should say?

Ms. SCHUBERT. I don't know if that is true. I am not sure about that.

Chairman MFUME. Do you think if you have 20 people making a decision that they will be more objective in reaching a decision that they all have to agree on, or do you think just the opposite?

Ms. SCHUBERT. They don't all have to agree on it. It is ultimately going to be the person with the highest authority, the authority to make that decision. So it may end up coming down to one person.

The process has been refined over the years to be as objective as possible. The differences are that different companies have different objective criteria.

Chairman MFUME. What about in an instance when we are talking about a lesser amount which, according to your model, means fewer people involved in the approval process, perhaps only one. Then doesn't that lend itself to less objectivity in the decisionmaking process and more subjectivity, particularly if you want to bring back what you called the old and arcane notions of character and capital?

Ms. SCHUBERT. Guidelines are given to the underwriters, which they have to follow. I don't have specific company guidelines, but when you are talking character, you are talking things like do they pay their bills, do they pay subcontractors, do they walk out on jobs? Those kind of things are important to know. That would be an objective criteria.

Chairman MFUME. The reason I am asking this is that most minority contractors, particularly those just getting in, are getting in on a lower dollar amount. Therefore, if they are getting in on a lower dollar amount and there is only one person making the decision and we see a high rate of rejections, it is conceivable that there are some biases built into the system; or it suggests that if minority entrepreneurs are getting in at that level, then perhaps the threshold, as Mr. Carradine suggested, ought to be raised so that the intent of the Miller Act, given the fact that this is no longer 1935 and dollars values are different, the intent of the act would still be carried out, while at the same time, not be punitive to minority contractors who are trying to get in for the very first time to get the experience that you need in order not to get rejected later on by not having experience.

Ms. SCHUBERT. I understand what you are saying. 1935 was actually not when the \$25,000 threshold was enacted. That was enacted back, I believe, in the 1960's, I think it was 1968. The initial threshold was much lower than that. It was raised to \$25,000 in 1968.

Chairman MFUME. It was. But the intent began in 1935. The intent was to, at least at a minimum, have a threshold that would not necessarily be punitive but at least would provide some security to the Government.

Ms. SCHUBERT. That is correct. We agree with that. We agree with the concept behind that. I think the question comes in where that threshold ought to be.

Surety bonds do provide protection, not only to taxpayers, and this is something that is very critical to recognize, it provides the protection also to subcontractors. To a subcontractor on a \$25,000 job, that is a lot of money for a lot of subcontractors. If you raise that threshold to \$100,000, you lose that protection for the subcontractors.

We have some statistics that I didn't bring with me today because I didn't know we were going to talk about the Miller Act threshold, but I can provide some answers on that question and statistics as to how many surety bonds are written for Federal projects that are actually less than \$100,000. It is a surprisingly large number.

Chairman MFUME. There are subcontractors saying that it is in their best interest to keep it at \$25,000, or is that the interpretation of your association?

Ms. SCHUBERT. Yes, I believe the American Subcontractor Association's official position is to keep the threshold at \$25,000. I believe Mr. Ruth could answer that question for you.

Chairman MFUME. Mr. Ruth?

Mr. RUTH. Yes, sir, that is true. Our position is that we would have no objection to the threshold being raised, providing that there was adequate protection for subcontractors. The issue of where the threshold belongs is not really our concern as much as having the payment protection for subcontractors.

I think that is the type of thing that we might be talking about in terms of escrow and direct disbursement.

Chairman MFUME. Mr. Huber, in your testimony, you made reference to the fact that oftentimes problems occur because contractors are really not seeking out and using agents that specialize in obtaining surety bonds or are up to date on what is the happening.

How do agents or producers, in your opinion, keep abreast of some of the tangible factors that each respective underwriter deems important in their own underwriting requirements?

I don't think they put out a trade journal to that effect. These seem to be very fluid and they oftentimes, I assume, are based on the economy. What are your thoughts?

Mr. HUBER. I think it is a full-time involvement in this business. The difference between our members and the normal property-casualty agent who is allowed to write a bond but has no knowledge of the surety marketplace; knows that maybe his companies that write property casualty insurance also can write surety. But he doesn't know the underwriters involved, doesn't know the branch office surety people involved.

It does require a constant communication between the producer and the companies that he represents.

Chairman MFUME. Just one other question.

Under the SBA Preferred Program, in your opinion, has your association written more bonds to minorities and women than it would have in the absence of that program?

Mr. HUBER. I think it has, yes, sir.

Chairman MFUME. Do you have any thoughts on the threshold question?

Mr. HUBER. I might relay just another statistic or another fact that came out of the survey that I referred to of our members. These were just only one-half of our 560 members who responded. But those 250 or so firms wrote 22,000 bid bonds for Federal contracts of under \$100,000.

Of those 22,000, 88 percent of them would have involved subcontractors or suppliers who would have not been protected by the payment bond if the threshold were raised to \$100,000 from \$25,000.

Chairman MFUME. Mr. Ruth, on the very first page of your testimony, you cite a Grant Thornton report which suggests that a contractor's creditworthiness in applying for bonding will become more stringent. Could you share with the subcommittee any infor-

mation that you may have that suggests that it will be, in fact, more stringent?

Mr. RUTH. Mr. Chairman, I believe we have made a copy of that Grant Thornton report available. I will make sure that you receive that.

What we are finding is that due to the economic pressures, a tremendous dynamic is unfolding where the subcontractor or contractor is up against a time constraint. Even if you have a relationship with the bonding company, we find that as the bid date nears, questions arise as far as the current status of your business.

I think that the stringency of the creditworthiness is a factor of economic times. It is happening both to minority- and women-owned firms and small emerging subcontractors.

Chairman MFUME. Did you mean, by any chance, also to suggest that there would be additional information required for financial presentation, disclosure of corporate and personal finances, or anything other than the time problem?

Mr. RUTH. Yes, sir. What we are finding is that as the bid date nears, there tends to be a growing crescendo of information back and forth between the bonding agent and the contractor and subcontractor.

What happens, sir, is that, let's say, I find a job that is to be bid next Tuesday. You call up the bonding company and you think you have a relationship. Then you find out they need this, this, and this. You provide that.

If you have a review statement, many times they will come back and say, gee, we need an audit statement now. The problem is not only getting that first bond, but as an ongoing basis.

I would like to just expand on my answer a bit. What happens is you do get questions back from the bonding agent. Many times there are questions such as we would like to see you have more capital in the business.

But what is more capital? It is the same, sir, as if I were going to Baltimore and I didn't know how to find Baltimore, and someone said, it is north of Washington, as opposed to, take Route 50 out and the Baltimore-Washington Parkway down. There is no path. It is a general type of information.

We are asking that contractors and subcontractors have a chance to really evolve and to have some ability to cure some of the deficiencies and really help the communication on both sides.

Chairman MFUME. Mr. Ruth, you also mentioned the use of "irrevocable letters of credit" in some circumstances. When do you think LC's could be used in place of surety bonding?

Mr. RUTH. We had a situation where our firm bid a job. The general contractor came back to us and said we will work this out if you pay for the cost of a bond. This is a private job, sir. It is our policy that if you pay for the cost of the bond, which would have been \$15,000 or \$18,000, we will go ahead and we will award you the subcontract.

I was thinking about it on the way home from his office. I called my banker up and I said: What would it cost to get a LC? When he gave me the amount, I called the fellow back and I said: Listen, rather than you or me eating \$18,000, or you eating \$18,000, here is a chance, why don't we give you an ILC for, say, 10 percent of the

subcontract amount until such time as we have substantial completion? We can try to agree on substantial completion.

The problem is that due to my involvement with the people on the panel and the American Subcontractors Association, I might have an opportunity to know about those avenues. Small and emerging firms probably don't have the same opportunity that I had. That is one of the reasons we think there needs to be an information exchange.

Chairman MFUME. Mr. Carradine, on page 5 of your testimony, you mentioned that your association had meetings with representatives of the surety industry and those associations to identify and to implement mutually acceptable actions. For the record, can you tell us what some of the those actions are that you identified and that you mutually agreed on?

Mr. CARRADINE. We are in the process of mutually agreeing still. We agreed to move forward on mutually agreeable actions later and to go forward and implement such actions. Several efforts were underway after a major meeting, and two of my colleagues here attended the meeting at the Surety Association of America in late January of this year.

One of the things that we proceeded to do as a result of that meeting was to develop an unified rejection form that we have now drafted and we are going through some internal review of it, and we will be providing it to Martin, to Lynn, and to Lloyd Provost of the SAA.

We talked about that extensively, on the whole, of clear understanding of rejection. They made arguments and points as to the possibility of us not wanting to have as much detail possibly of a negative history being documented, which is a valid point to make.

Our feeling and the feeling of our membership was that the opportunity or possibility of getting an opportunity out weigh the potential of documenting the negative aspects of the firm.

Another very positive aspect, most recently, in fact, just these past few days, I spoke at the regional meeting of the National Association of Surety Bond Producers, Martin's organization, at their Southeastern Regional Meeting, on the whole issue of bonding opportunities for minority contractors and the fact that they are missing a major opportunity to develop a much larger base by aggressively and actively seeking out to provide those to minority contractors.

I will be speaking to another two sessions of their organization in regional meetings, and my colleague, Bob Johnson, will be speaking to a fourth. We will blanket the 500-some members of NASBP with this issue. We are working with them to develop a specific outreach program where they can identify surety agents who will agree to work specifically with our agent and other minority contractors, where we can begin putting a uniform denial form in process.

Those are some of the things. It doesn't take away from our feeling that we need the surety legislation in place, though.

Chairman MFUME. I may have misrepresented your organization when I indicated you were advocating lifting the threshold. What you really said is you request a review.

Mr. CARRADINE. We tempered our words, but we actually do advocate lifting the threshold, that is true.

Chairman MFUME. You listed two concerns and you suggested that neither of which deals with payment protection. I assume that is a concern after you heard Mr. Ruth?

Mr. CARRADINE. It has been brought up. I find it interesting that, at least from the other side on that issue, that they often speak to the concerns of our constituency with respect to that. We don't get as much from our membership in terms of the issue of payment protection as we do with the feeling that they need to have the opportunity to participate.

I agree it is a concern. It could be addressed through other methods. It doesn't mean you have to throw out the baby with the bath on this issue. You can achieve both things.

Chairman MFUME. Can you comment on the disparity in the data in your survey which Mr. Huber outlined?

Mr. CARRADINE. Which aspect.

Chairman MFUME. Any of them. Did you notice any? Was it just me?

Mr. CARRADINE. We surveyed our membership, 3,500 members. They are still coming in. In any event, we found our members articulated that there was perceived discrimination on their part in receiving bonds.

Mr. Cruz was one of the members who has articulated that he had experience in that regard. A number of our members, the majority, in fact, indicated they had trouble getting bonded. So we do differ with some of the findings that he has from his survey.

Chairman MFUME. Mr. Huber?

Mr. HUBER. Our survey results were based on the contractors who found their way to one of our members. That is the point I am trying to get at today, the need for contractors to find a professional surety agent. Admittedly, we have not done a very good job of letting the career field of surety underwriter and producer be widely known. There are too few, I would admit, of agents that specialize in this area.

Chairman MFUME. I want to thank all of you being here and for your time, and obviously for what you have contributed to the discussion on this issue, for a formal record that I hope my colleagues on the committee the have an opportunity to review. It has been very useful.

Ms. Schubert, Mr. Huber, Mr. Carradine, thank you.

[Whereupon, at 12:25 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

APPENDIX



NATIONAL ASSOCIATION OF MINORITY CONTRACTORS

1333 F Street, NW • Suite 500 • Washington, DC 20004 • (202) 347-8259

July 23, 1993

The Honorable Kweisi Mfume
Chairman, Subcommittee on Minority Enterprise,
Finance and Urban Development
Committee on Small Business
U.S. House of Representatives
568-A Ford Office Building
Washington, D.C. 20515

Dear Congressman Mfume:

On July 20, 1993, I presented testimony, on behalf of the National Association of Minority Contractors (NAMC), before their Subcommittee's hearing on discrimination in surety bonding. Other testimony at that time referred to your bill, the "Minority Business Development Act of 1993", H.R. 278. Therefore, I would like to augment my testimony by stating NAMC's support for the bill and our suggestion for strengthening its provision for surety bond assistance. I respectfully request that the following be added to my testimony:

"NAMC enthusiastically supports the passage of H.R. 278, the Minority Business Development Act of 1993." We believe that its various provisions would provide important improvements in the manner in which MBDA could assist the development of minority business enterprise.

NAMC also suggests that the bill be amended to provide more specifically for "technical assistance" in the surety field. The existing Section 202 (a) (2) provides for a study which would include a surety bond referral assistance program.

Last year, NAMC completed a research and education project for MBDA under which we recommended specific actions for MBDA which we feel would result in more effective bonding assistance. Our recommendations were generated from extensive surety research and the application of considerable expertise and experience. I am attaching two project reports for your reference. Our recommendations for bond underwriting support systems are contained in the last section of the "Final Report." Our recommendations for continuing training are contained on pages 16 and 17 of the "Summary Report" on the surety assistance seminars.

STATEMENT - JULY 20, 1993

Subcommittee on Minority Enterprise, Finance and Urban Development

Thank you, Mr. Chairman.

It is a pleasure to be here this morning. I, too, would like to welcome our guests and thank them for joining us. I look forward to their testimony.

Mr. Chairman, the problems that minorities face in obtaining proper surety bonding are certainly not new, but they are real and immediate to the minority businesses of the 33rd Congressional District of California. The problem that minorities face in proper bonding is, as well, a prime example of the problems minorities face in making a variety of financial services work for them.

Sometimes, the problem in obtaining these financial services is a lack of understanding and knowledge by minority businesses about standard banking and credit procedures. Sometimes, the problem is merely a lack of experience in dealing with lawyers, accountants, bankers and financial agents. Sometimes, the problem is complex government procedures and red-tape. I believe we can and should be able to deal with these problems. There are, however, those cases, and they are the worst, when the problem is simply and purely discrimination.

There has always been subtle and overt discrimination in the delivery of financial services to minorities. Sometimes, it takes the form of extra requirements applied to minority businesses. Sometimes, it is a requirement applied to minorities in a punitive and restrictive manner. Sometimes, it is simply loans and credit that are denied without explanation. In all these discriminatory practices, the end result is the same. Minorities are prevented from participating in the normal economic activity of the community. Minorities are denied the right and the opportunity to progress and to make a better life for themselves and their posterity.

Mr. Chairman, I thank you for holding these hearings so that we might confront this problem, and work to correct it. Thank you Mr. Chairman.

STATEMENT OF
ARNOLD P. ACKER, CEO
OF
FORCON-AACON, INC.

Before the Subcommittee on Minority Enterprise,
Finance, and Urban Development

July 20, 1993

Good morning Mr. Chairman, members of the subcommittee and attendees. My name is Arnold Acker of Forcon-Aacon, an affiliate of Forcon International Corporation. I would like to present a program that would afford qualified small and minority construction contractors to obtain bonding with significantly reduced risk to bonding companies.. We refer to this program as Disbursement Control.

DISBURSEMENT CONTROL

Construction Disbursement Control is a highly effective technique for preserving the linkage between construction contract income and costs. Prompt progress payments to subcontracts and suppliers is a critical element in the timely completion of a construction project. Direct linkage between contract income and costs is a "trust" obligation of the contract subject to numerous Federal, State, and local statutes, regulations and contracts.

Approximately seventy percent (70%) of aggregate contract bond losses occur as payment deficiencies as opposed to performance losses. Any program that can assure that contract income is utilized first to pay for the work will assure compliance with public policy, reduce costs, facilitate more timely project completions and ultimately save the public money.

Retention and Payment Bonds have been used for many years by the construction industry to encourage contractors to properly apply contract income to the projects on which it was earned. Both of these methods are tested and effective; however, both create their own problems and neither assures that prompt payments will be made to vendors. Additionally, vendors often have to rely on expensive legal remedies to collect legitimate accounts payable related to bonded

construction contracts.

Construction Disbursement Control is a program, or express contractual requirement; whereby, an independent third party professional governs the disbursement of construction contract income. The contractor retains full control over the project activities, the methods and means for construction, administration of the contract, the risks and benefits of the contract, and the disbursement of net earnings transfers to the contractor from controlled funds. Only the costs expended directly by the contractor for labor, field general conditions and "net earnings", subject to the disbursement agreement, flow to the contractor.

In addition to preserving earned contract income for its intended purposes, the Disbursement Control process assures a thorough and timely project specific job costing system, utilizing reliable and generally accepted accounting procedures.

HOW DOES THE GOVERNMENT BENEFIT?

Disbursement Control opens the market to otherwise unbondable contractors and subcontractors. The construction market as a whole becomes more accessible to new, small, or disadvantaged contractors. Equally important, Disbursement Control reduces accounts payable risks and provides a tested early warning system if construction costs exceed contract income and/or are projected to exceed income. Contract income is preserved and the ability to address problems or failures is expedited. Cash flow problems are reduced; thereby, increasing the probable success ratio of the project. Additionally, reliable project specific job costing records are

available from an independent third party to facilitate change order negotiations and owner audits.

HOW DOES THE CONTRACTOR BENEFIT?

Benefits for contractors are numerous. The opportunity to perform work the contractor might otherwise have been precluded from performing is obvious. Without the ability to acquire a bonding line of credit, which frequently requires substantial net worth, collateral and/or demonstrated past experience, many viable contractors are shut out from the market. They can not get the work to build a track record and working capital. Disbursement Control does not require a prequalification process and it allows the contractor to go to an owner or general contractor with increased assurances that contract funds will not be diverted or squandered, and potential financial problems will be promptly identified.

Contractors are also able to negotiate improved credit terms. Many new or financially marginal contractors have difficulty receiving favorable credit terms. With or without payment bonds, subcontractors and suppliers are leery. The lack of competitive credit terms ties up cash, adds to project costs, decreases efficiency through purchase/delivery delays and is a continued distraction for management. Often the credit savings, improved project scheduling and prompt payment discounting more than fully cover the costs of Disbursement Control.

Finally, job cost accountability is improved. Risks and problems of lien/stop notice claims are reduced. Diversion or loss of proceeds through front loading is eliminated. The contractor has

the benefit of timely project financial data and tested personnel and financial systems to track costs and project profitability. Production under-runs or budget/estimate problems become more apparent when there is still time to solve the problem. Full use of the accounting services available from some Disbursement Control Agents reduces and/or eliminates the need for contractors to develop sophisticated internal systems. "Back Office" contractor costs are reduced. Financial data is more current and the contractor's accounting costs become project overhead, directly related to the contractor's income volume. Overall, costs are reduced and the contractor does not have to carry much of his accounting cost at times of low volume.

THE DISBURSEMENT CONTROL PROCESS

Disbursement Control Agreement

Basic to Disbursement Control is the absolute control of all project funds. This control is initiated simultaneously with the award of a contract by the signing of the Disbursement Control Agreement between the contractor and the third party Disbursement Control Agent. A part of the agreements implement the assignment of all project draw proceeds from the owner to a project specific disbursement bank account as set forth in FAR, Assignment of Claims, Act of 1940, Amended 31 U.S.C. 3727, 41 U.S.C. 15.

Schedule of Values

With the Disbursement Control Agreement in place, the contractor is then required to provide all pertinent project data, including the schedule of values, to the Disbursement Control Agent.

All data is analyzed and reviewed by the Disbursement Control Agent with special attention focused on the schedule of values and the elimination of any front loading of the project.

System Implementation

Once the schedule of values has been approved, this data, along with the contractor's original estimate data, is input into the cost accounting system. This system formulates the base information on the project which is continuously updated and monitored until the completion of the project.

Project Specific Disbursement Account

Once all the base project information has been input into the Disbursement Control Agent's system, the disbursement control accounting department opens a project specific disbursement account under the Federal ID number of the contractor. The title of this account is in the name of the contractor, and the Disbursement Control Agent is listed as a secondary account holder. The funds are then "locked up" pursuant to the Disbursement Agreement.

Draw Requests/Proceeds

Throughout a project, the contractor is required to supply draw request information, including original invoices and copies of subcontract agreements and purchase orders to the Disbursement Control Agent. After the Disbursement Control Agent has notified the contracting officer of his approval of this request, the invoices are passed to the disbursement control accounting department for processing.

The Disbursement

As the contractor's draw proceeds are received by the Disbursement Control Agent, they are deposited directly into the project specific disbursement account. All invoice data previously input into the system then generates checks made payable to subcontractors, suppliers and to the contractor. All necessary accounting reports and job costing data are sent to the contractor and agency/owner, if applicable.

Retainage

If a governmental agency/owner requires that retainage be held on a project, the Disbursement Control Agent's system can easily accommodate this request. This retainage may be held on a project by project basis and is based on a standard percentage of each draw. Retainage is held until the project is complete and final payments have been made.

Review

If appropriate, all financial reports are reviewed by the Disbursement Control Agent's technical staff. Any potential problems are then called to the attention of the contractor and the contracting officer.

Partial/Full Lien Waivers

Consistent throughout the payable activity is the completion of partial and full lien waivers. These controls are put in place prior to any payments being made to subcontractors and suppliers. It is through this mechanism the owner can be assured of project completion without there being liens placed on a project or payment bond claims filed. Timely project completions are enhanced and disputes are minimized.

Payroll/Payroll Taxes

Unpaid payroll taxes constitute one of the largest threats to any construction project. To eliminate this problem, strict adherence to certified payrolls and paid tax receipts is required. This process is automatic within a disbursement control system and is project specific.

Prompt Repayment

As each draw is received, funds are utilized to promptly pay subcontractors, suppliers and overhead according to the original budget. With this system in place, a comfort level is established and maintained throughout a project for all parties concerned.

WHAT ABOUT THE COST?

The fee associated with a Disbursement Control program is borne by the contractor, and in many cases the fee can be built into the general and administrative costs of a project. The Disbursement Control fee is usually a fixed percent of the total project cost, paid out over the life of a project, as draw proceeds are received. Rates for Disbursement Control services may vary in conjunction with the nature, size and scope of any one individual project. When the benefits to the contractor, such as reduced bond cost, better credit terms, increased sales volume, discounted subcontract and material prices, more timely completion schedules, and fewer disputes are included in the Disbursement Control fee equation, the overall results can be an increase in project profitability and decrease in home office overhead. Costs for Disbursement Control typically run three-fourths ($\frac{3}{4}$) of one percent (1%) or slightly more of the construction contract amount, with a minimum fee for small projects under \$100,000 to \$150,000.

Opponents of Disbursement Control Programs contend that it is too costly and might be viewed by some contractors as interfering with their standard business practices. Others contend it will do harm to contractors who are marginally financed because they can not divert proceeds from one job to another that might be in a cash deficit position, or to pay for administrative and overhead expenses. We are of the opinion the savings to the Contractor to be derived from better credit terms, reduced overhead, prompt vendor payments resulting in fewer disputes and more timely project completions, will far outweigh the opponents concerns.

CONSTRUCTION MANAGEMENT AND TECHNICAL SERVICES

In addition to Disbursement Control, many Disbursement Control companies also offer additional contractor services, including:

- * Assistance with construction scheduling; CPM's, network analysis
- * Assistance with maintaining cost control data
- * Original take off estimating
- * Take off auditing and review
- * Subcontract negotiations and contract preparation
- * Quality Control representatives
- * Closeout documents, as-built drawings, and assembly of operations/maintenance manuals
- * Dispute avoidance procedures

OUTLINE

CONGRESSIONAL TESTIMONY FROM MR. CRUZ

Mr. Chairman and honorable members, I wish you a good morning. My name is John B. Cruz III, and I am the president (and CEO) of John B. Cruz Construction Co., Inc. of Roxbury, Massachusetts, a 100% owned and operated minority firm. I appreciate the opportunity to appear before this distinguished committee and describe my experiences in trying to secure the kind of contract bond arrangements which would enable my firm to grow and prosper in ways that are consistent with our abilities, resources, experiences and the opportunities available. The fact is that racism and prejudice are still alive and well in America and have caused us to scale higher heights and labor with greater burdens than that of our fellow majority contractors.

I would like to preface my remarks by telling you a bit about myself and John B. Cruz Construction Company. My father founded this firm in 1948 as a carpentry subcontracting firm; so we have been in operation

continuously for over 45 years. As a general contracting firm we have been in operation for over 25 years. My father, who at 74 years old is still actively involved working 10-12 hours a day, every day. Both him and I operate the firm. We have been able to realize annual receipts as high as \$20,000,000 and have completed single projects as large as \$15,000,000. We specialize in general contracting, and have constructed various projects such as building a runway for the United States Air Force; a 17-story elderly housing development; a 43,000 square foot plant for the Digital Equipment Corporation and in addition have worked for various corporations and universities such as IBM, Polaroid, Raytheon, Osco Drug, Star Market, Harvard University, Boston College and Simmons College. We, along with our minority subcontractors create jobs, primarily for minority workers who live in the community and we have a rather significant impact on the economy of the minority community and, indeed, on the economy of The Greater Boston Area. Let me please give you an example: Presently, we employ approximately 40 employees. Ninety percent are people of color. Our employment has reached over 80

employees. During a recent five-year period (before the downturn of the New England economy) we, as a general contracting firm, contracted out approximately \$30,00,000 to minority and female owned subcontracting firms. Over that same period we created 350 construction jobs and approximately 70% of those employees were minority workers. During the same 5-year period the combined payroll for minority workers employed by the Cruz Companies and those employed by our subcontractors total \$25,000,000. Additionally, we employed the services of minority professional firms such as architects, lawyers, accountants, and various consultants. The expenditure for their services was \$2,000,000.

Presently, we have \$8,000,000 in contracts--over 70% of those dollars are contracted with minority and female firms, and over 70% of the workers employed on the projects have been minorities.

I have served as the President of the National Association of Minority Contractors; and I continue to serve as a member of NAMC's Board of Directors. I donate my time, money and energy to NAMC and other minority business groups because I believe, very strongly, that it is

extremely important for the entrepreneurial spirit and traditions to be expanded in our minority communities. I believe that business opportunities must be greatly improved for minorities and I would like to do my part to help other minority businessmen and women. Just as my father passed certain traditions and resources to me, I would like to help my fellow minority business enterprises attain the solid foundations and means to spread true entrepreneurship throughout minority communities.

My firm's experiences with bonding and my involvement with NAMC and other minority associations have given me both a personal and comprehensive sense of the problems faced by minority contractors. By way of summary, minority contractors find it significantly more difficult to obtain adequate bonding arrangements under reasonable conditions than non-minority contractors. Minority contractors experience more obstacles in obtaining initial bonds and in obtaining adequate bonding capacities. Moreover, minority contractors are more likely to face demands for higher rates, inappropriate collateral and unnecessary escrow accounts. These problems are not diminishing. Instead, in my opinion, they are often

growing.

Let me tell you about our firm's experiences with bonding over the last 25 years. Our first attempt to secure a bond was in 1969, the contract value was \$60,000. After several refusals, we finally found a company willing to place the bond. However, besides the standard personal guarantees and indemnifications required by the bonding company, my father also had to place an additional \$10,000 of his savings into a special account that the bonding company controlled. This was over and above the usual 10% retained earning requirement the bonding company applies to construction firms in order to establish a bonding line. To us, this was a case of over reaching and double dipping. We were, however, fortunate and thankful for the opportunity to receive our first bond. After completion of the project, we were then able to secure an additional bond for \$130,000. After that project's successful completion we were given the opportunity to construct a \$700,000 housing project. We tried unsuccessfully to find a company to bond us. After several rejections and an enormous amount of time, we were forced to

look for other alternatives. Fortunately, we were able to obtain a letter of credit for 10% of the value of the project which the Funding Agency accepted, in lieu of the bond. The project was completed on time and within budget. We went on to complete another project for \$1,000,000 with the same Letter of Credit alternative because of our inability to obtain a Bond.

After completion of those two projects using letters of credit in lieu of bonds, our firm received a contract to build a Star Market/Osco Drugs shopping center. This complex, an approximately 100,000 square foot facility, was our largest project to date, \$1,500,000. This too was completed on time and within budget. We received enormous positive press from the construction of this project. It was Star Market's/Osco's first project in a black community and the newspapers and television stations aired positive editorials regarding the shopping center and the minority construction firm that built it.

We then began to make some in-roads in our attempt to penetrate the bonding arena. Based on the profits from our previous project,

coincidentally, the ones we were not able to secure a bond for, and along with our increased name recognition and experience, we were finally able to bond our next project a \$1,000,000 health center and we were able to secure a bond and secure a \$3,000,000 bonding line.

At this point we felt we were prepared to grow and become competitive until we faced our next problem with a bonding company. This was a result of a \$2,000,000 with the City of Boston project, which we requested and received permission to bid. But much to our dismay, a couple of weeks into the bid process, we received a call saying our bonding company had reevaluated our capacity and was denying the bond. Naturally, we had to change our bonding agent and our bonding company. By the way, during this same period, a remark was brought to my attention by that a senior bond underwriter made in regard to our firm. The remark was "The only success Cruz has had is where some white guy is leading him by the nose.". How many times are we judged by these racist and inflammable statements rather than our true capabilities? As usual, we have learned to go through, around or over whatever

obstacles we face.

With our new agent and bonding company, we received a tremendous opportunity; a minority community group wanted us as their general contractor for their \$4,000,000 project. This was in 1978, and our bonding capacity was approximately \$3,000,000. Through an innovative program run by an agency called Minority Contractors Assistance Program (MCAP), a program funded by the Ford Foundation and various surety companies. MCAP's assistance to us was in the form of providing a \$00,000 letter of credit that could be drawn on and used to finish the project in case we defaulted. This additional letter of credit helped us secure the \$4,000,000 bond needed. The project was finished on time but unfortunately, the owner was disputing \$300,000 worth of change orders and additionally a subcontractor of ours filed bankruptcy during the construction period. He was bonded and we filed a claim against his bond. At this same time we also had a contract with Harvard University for \$700,000 which turned out to be a problem project for us and we lost money on this particular contract. Well, instead of working with us so we

could secure additional work until our claims were settled and we worked out our problems, the bonding company unceremoniously dumped us. Shut us off completely! Period! We were not able to even secure a revised bonding amount until our claims have settled and our working capital was replenished, even at 50% of our previous capacity or one third of our previous capacity, the answer was still no!, Nothing!, Zippo! It was the 'kiss of death' similar to having the plague. How could a Black owned construction firm that was just dropped completely by a major bonding company find another bonding company with that stigma attached to our company? The surety industry is a small, tightly knit group. Although we tried, we found ourselves again with no bonding in the standard surety markets.

Personally, I swore that I would have the satisfaction of writing the bonding company to show them they were wrong and we would prevail in our efforts to secure our change orders. Again we were fortunate to be in the 8A Program we were able to secure contracts and bond them under the "Personal Surety" regulations. These contracts even though smaller

than we had previously completed, helped keep the company afloat.

During this time the Digital Equipment Corporation decided to build a manufacturing plant in the Black community. We were picked to build the plant for them, a \$2.4 million dollar project and significantly, there were no bonding requirements. An additional opportunity during that same time period was the contract to build a \$3,000,000 housing development for State Housing Financing Agency. Again, we were able to use a letter of credit in lieu of a bond, which was acceptable to the agency. Again, both of the previously mentioned projects were completed successfully, on time, and within budget.

If it were not for these examples that I have given of projects (that we were able to secure without a bond) which provided work for the company during those two-plus years. The time required to resolve our change order disputes and our subcontractor's claim, which we resolved in our favor, we would have been out of business or reduced to the level we were when we first started out as a general contracting firm.

The important fact or issue here is that for three years we were

unable to obtain surety from the standard bond market. Yet through alternate sources we were able to secure work in order to grow and prosper. The profits derived from these projects were instrumental in adding to the retained earnings for the company which increased our bonding line accordingly. In 1982 we re-entered the standard bond market with another agent and bonding company who genuinely believed in our capabilities, our character, and our resiliency.

For the next 5-6 years we experienced a good relationship with our agent and bonding company. Our total capacity grew to \$35,000,000 and our single largest project was \$15,000,000. Unfortunately, the company we were with decided they did not want to conduct their insurance business in the State of Massachusetts and left the state. Once again, we were in the market for bonding. After a long and laborious process, including one incident where a middle staff executive misrepresented and distorted information on our firm which was sent out to senior levels of staff for their decision on bonding our company. We have a copy of this intercompany memorandum sent mistakenly with other office mail to our

office. After again, a time-consuming procedure, we were able to secure another agent and bonding company. However, our bonding line was reduced by approximately 25%.

We continued with that bonding company for the next three years with our largest single bond of approximately 13.5 million dollars. Unfortunately, because of the downturn in the economy, we found ourselves once again facing a bonding problem. We unfortunately had the distinction of having two banks fail, leaving us without lines of credit. We were also engaged in a dispute with an owner/architect for a project delay due to design errors which we eventually settled for \$700,000.

Dejavu—again we found ourselves unceremoniously dumped! Not that we were being limited or restrained to a lower bonding line until we cleared up the problem or the concerns. No—just left to dangle with no mechanism to bring in additional contracts!

How could a minority owned construction firm secure a new bonding company amid the chaos and uncertainty of a disastrous New England real estate and construction market? Needless to say, we couldn't secure

bonding once again with the standard surety market. Because of our inability to obtain bonding, we actually slipped further into a hole. We had no way to generate cash flow or profits to defray our overhead costs.

The only alternative that was left for us was the "collateralize" market. This is where a contractor has to post anywhere from 5% to 20% of the value of the contract as collateral with the bonding company in order to obtain the bond. Additionally, there is usually an escrow agreement where the bonding company controls the account where the project funds are deposited and pays the project's expenses from this account. Besides that the fees for these collateralized bonds run from two to four times more than the standard surety fees.

Even in this arena, minority contractors are still facing problems in obtaining the needed bonding line. We recently obtained a verbal commitment for three projects totaling \$8,000,000. When it came time for the bonds to be placed, we found that the company now was changing the original requirements and the commitment amount. This almost caused us to lose one of our contracts. We were fortunate enough to find

another collateralized bonding company to provide the necessary bonds.

All of the various alternatives to the standard bond market cost the contractor enormous amounts of time, energy and money. But it is better than no contract at all.

Almost 30 years ago, just out of college, I didn't think I would have to repeat to my son and daughter the adage my father drilled into me, "You have to be twice as good to get half as much." And over 30 years ago when I was a youngster in high school deciding I wanted to follow in my father's business, I searched for a mentor or a symbol of success to emulate, that company was a Massachusetts construction company named "The Perini Corporation". I read whatever material I could find on the firm and found out they were a third-generation family run business. I could see the various buildings they were constructing in or around the city. I longingly looked at their name placed on the tower cranes high above the city and promised myself that one there would be a crane high above the city with the name Cruz.

Hopefully our firm can be a role model and mentor and a symbol of

success that inspires an inner city youth (who won't have to look outside his and her community and race) to decide that he or she would like to be another Cruz Construction Company.

I assure you, honorable Chairman and my fellow minority contractors, that I shall continue to give of my time and energy to try to bring about equal surety opportunities for minority contractors -- the kind of opportunities my father would have expected for this time in history.

On behalf of my company, I ask the Subcommittee to work with the National Association of Minority Contractors to improve the fairness with which bonds are considered for minority contractors.

The regrettable history of discrimination in this nation is significant. It cannot be ignored, but as a pragmatic businessman, I must look forward. I invite the members of this subcommittee and congress to join me and NAMC in reducing these bond problems. Let us enter the 21st century with more equitable bond opportunities for all qualified contractors. This concludes my prepared testimony. I would be happy to respond to any questions you might have.

ELEANOR HOLMES NORTON
DISTRICT OF COLUMBIA

COMMITTEE ON
PUBLIC WORKS AND TRANSPORTATION

SUBCOMMITTEES
VICE CHAIR PUBLIC BUILDINGS AND GROUNDS
WATER RESOURCES AND ENVIRONMENT

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POST OFFICE AND CIVIL SERVICE

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CHAIR COMPENSATION AND EMPLOYEE BENEFITS



Congress of the United States
House of Representatives
Washington, D.C. 20515

COMMITTEE ON
THE DISTRICT OF COLUMBIA

SUBCOMMITTEES
CHAIR JUDICIARY AND EDUCATION
FISCAL AFFAIRS AND HEALTH

JOINT COMMITTEE ON THE ORGANIZATION
OF CONGRESS

DEMOCRATIC STUDY GROUP
EXECUTIVE COMMITTEE

**TESTIMONY OF CONGRESSWOMAN ELEANOR HOLMES NORTON
BEFORE THE HOUSE SUBCOMMITTEE ON MINORITY ENTERPRISE,
FINANCE AND URBAN DEVELOPMENT
HEARING ON DISCRIMINATION IN SURETY BONDING**

July 20, 1993

Mr. Chairman, I appreciate your unfailing work to promote economic equity for all Americans and especially today's hearing that seeks to help eliminate discrimination in surety bonding, a deep-rooted impediment to equality for people of color, women and many other Americans as well. I also very much appreciate your co-sponsorship of H.R. 1464, the Equal Surety Bond Opportunity Act, a bill I first introduced last session and have now re-introduced to help create more equitable bond opportunities for small, minority-owned and women-owned businesses.

First, I am pleased to report that today Senator Paul Simon and Senator Carol Moseley-Braun are re-introducing H.R. 1464 in the Senate. Last session, Senator Simon introduced a companion bill to the one I introduced in the House and last Fall I had the opportunity to testify on the issue of access to surety bonding before Senator Simon's Judiciary Subcommittee on the Constitution. In fact, last session we did enact one of my surety bills that I will discuss presently, and with the further impetus provided by your hearing today, Mr. Chairman, I believe that we can get H.R. 1464 passed in the House and Senate this session.

One of the most frequent and continuous barriers to equal economic opportunity has been this financial requirement, shrouded in a technical mystique that is not well understood by the public. Surety bonding is required to bid on all federal construction projects that cost in excess of \$25,000, all federally-assisted construction projects in excess of \$100,000, and most other public construction (state as well as local). Surety bonding requirements, however, are not restricted to government contracting. Increasingly, private construction contracts also require surety bonding. As surety bonding has become a widespread requirement for competition, the inability to obtain surety bonding can cripple a construction firm, especially a small or nascent one.

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The principal source of bonding is private, for-profit corporate surety firms. These sureties determine the bond eligibility of a contractor on the basis of underwriting standards which are not always specified.

During my research on this subject, I learned that small businesses -- particularly those owned by women and minorities -- often have been denied access to adequate surety bonding. Small businesses assert that the decisions of corporate surety firms all too frequently impede their development and survival. Through conversations with the National Association of Minority Contractors (NAMC) and the Women Construction Owners and Executives (WCOE), we learned that both organizations have members who have encountered discriminatory practices by individual surety agents. Although the reasons the agents give for denial generally reflect more subtle forms of discrimination, WCOE informed me of instances in which the reasons given for the denial of bonding include not being married, being a woman, or being an African American woman. These reasons are clearly discriminatory.

Last year Congress acknowledged the importance of this issue when it passed the Small Business Credit Crunch Relief Act and included legislation to study the problem of discrimination in the surety bonding field, a bill that I had introduced. Now part of Public Law 102-366, the survey provision requires the General Accounting Office to conduct a comprehensive survey of business firms, especially those owned by women and minorities, to determine their experiences in obtaining surety bonding from corporate surety firms. Our research showed the need for national documentation regarding the various problems small businesses encounter in obtaining surety bonds since only limited surveys had been conducted by private sector firms, associations, and academic institutions.

GAO expects to provide Congress with the results of its survey later this year. In any case, we certainly do not need to wait for the results of any survey to mandate fairness in the surety bonding field, where existing surveys document discrimination clearly enough for purposes of remedial action.

The bill I have introduced this session, the Equal Surety Bond Opportunity Act (ESBOA), has an important and successful precedent. It is modeled after the Equal Credit Opportunity Act. The new Act will prohibit sureties from discriminating on the basis of race, color, religion, national origin, sex, marital status, sexual orientation, or age (if the applicant has the ability to contract). In addition, it will prohibit discrimination because an applicant in the past has obtained a bond through a special bond guarantee program designed to help small and emerging firms obtain surety bonding, or because an applicant has exercised her rights under this Act. The bill provides for civil liability for discrimination, including actual damages, equitable relief, and attorney's fees.

The ESBOA also requires that surety firms electing to seek approval by the Treasury Department in order to provide bonds on federal contracts meet more stringent requirements. A surety or its agent will be required to notify a contractor, within 20 days of receipt of a completed application for a bond, of the action taken on its application for a bond. The surety

will also be required to provide contractors whose application for a bond has been rejected with a written statement of reasons for such action.

I am told by NAMC that minority contractors seldom receive clear reasons for bond denial or the kinds of suggestions that would help them meet reasonable underwriting standards in the future. H.R. 1464 simply encourages fairness in existing processes. What this bill says to surety bonding firms is that if you want to be Treasury listed, you will provide certain information when you deny a bond to an applicant. Since the federal government essentially has contracted out the pre-application screening process to private surety bonding companies, it is only reasonable to ensure that the sureties are following fair procedures just as civil servants must do when reviewing, awarding and denying federal contracts.

The disclosure of pertinent information to rejected applicants is an equitable principle familiar throughout the federal acquisition process. For example, when a small business is turned down for a government contract, that business can get a negative pre-award survey. Armed with this information, the business can contest the award or use the information to be better prepared for the next award competition. The more a business knows about what is wrong with its proposal, the greater the likelihood that the next time the business will submit a better and more competitive proposal.

H.R. 1464 will help create an environment in which qualified small business firms, particularly those owned and controlled by minorities and women, can successfully obtain adequate surety bonding. This legislation will enable us to ferret out continuing biases in the industry. Whatever these prejudices may be, getting rid of them will open up the industry, creating entrepreneurial and employment opportunities and making the industry more competitive.

Mr. Chairman, your attention to the problems in access to surety bonding will serve to bring us closer to the passage of H.R. 1464. I look forward to continuing to work with you and with associations that represent small, minority and female contractors to reduce and eliminate barriers to economic equity for all Americans. I thank you, Mr. Chairman, for the opportunity to testify here today.

103D CONGRESS
1ST SESSION

H. R. 1464

To prohibit discrimination on the basis of certain factors with respect to
any aspect of a surety bond transaction.

IN THE HOUSE OF REPRESENTATIVES

MARCH 24, 1993

Ms. NORTON (for herself, Mrs. MINK, and Ms. PELOSI) introduced the
following bill; which was referred to the Committee on the Judiciary

A BILL

To prohibit discrimination on the basis of certain factors
with respect to any aspect of a surety bond transaction.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Equal Surety Bond
5 Opportunity Act”.

6 **SEC. 2. EQUAL SURETY BOND OPPORTUNITY REQUIRE-**
7 **MENTS.**

8 (a) **ACTIVITIES CONSTITUTING DISCRIMINATION.**—It
9 shall be unlawful for any surety to discriminate against

1 any applicant, with respect to any aspect of a surety bond
2 transaction—

3 (1) on the basis of race, color, religion, national
4 origin, sex, marital status, sexual orientation, dis-
5 ability, or age (if the applicant has the capacity to
6 contract);

7 (2) because the applicant has in good faith ex-
8 ercised any right under this Act;

9 (3) because the applicant previously obtained a
10 bond through an individual or personal surety; or

11 (4) because the applicant previously obtained a
12 bond through—

13 (A) any bonding assistance program ex-
14 pressly authorized by law;

15 (B) any bonding assistance program ad-
16 ministered by a nonprofit organization for its
17 members or an economically disadvantaged
18 class of persons; or

19 (C) any special purpose bonding program
20 offered by a profit-making organization to meet
21 special needs.

22 (b) ACTIVITIES NOT CONSTITUTING DISCRIMINA-
23 TION.—It shall not constitute discrimination for purposes
24 of this Act for a surety—

1 (1) to make an inquiry of marital status if such
2 inquiry is for the purpose of ascertaining the sure-
3 ty's rights and remedies applicable to the granting
4 of a bond and not to discriminate in a determination
5 of bondability;

6 (2) to make an inquiry of the applicant's age if
7 such inquiry is for the purpose of determining the
8 amount and probable continuance of bondability; or

9 (3) to make an inquiry as to where the appli-
10 cant has previously obtained a bond, in order to de-
11 termine bonding history, or other pertinent element
12 of bondability, except that an applicant may not be
13 assigned a negative factor or value because the ap-
14 plicant previously obtained a bond through—

15 (A) an individual or personal surety;

16 (B) a bonding assistance program ex-
17 pressly authorized by law;

18 (C) any bonding program administered by
19 a nonprofit organization for its members or an
20 economically disadvantaged class of persons; or

21 (D) any special purpose bonding program
22 offered by a profit-making organization to meet
23 special needs.

1 (c) ADDITIONAL ACTIVITIES NOT CONSTITUTING
2 DISCRIMINATION.—It is not a violation of this Act for a
3 surety to refuse to issue a bond pursuant to—

4 (1) any bonding assistance program authorized
5 by law for an economically disadvantaged class of
6 persons;

7 (2) any bonding assistance program adminis-
8 tered by a nonprofit organization for its members or
9 an economically disadvantaged class of persons; or

10 (3) any special purpose bonding program of-
11 fered by a profit-making organization to meet special
12 needs;

13 if such refusal is required by or made pursuant to such
14 program.

15 (d) REASONS FOR ADVERSE ACTION; PROCEDURE
16 APPLICABLE; DEFINITION.—

17 (1) NOTICE REQUIRED.—

18 (A) IN GENERAL.—Except as provided in
19 subparagraph (B), any surety approved under
20 section 9304 of title 31, United States Code,
21 shall notify an applicant of the surety's action
22 on a completed application before the end of the
23 10-day period beginning on the date the appli-
24 cation is filed with the surety.

1 (B) EXTENSION.—The 10-day period re-
2 ferred to in subparagraph (A) may be extended
3 an additional 10 days if the surety has not is-
4 sued a bond to the applicant during the 1-year
5 period ending on the date the application is
6 filed with the surety.

7 (2) STATEMENT OF REASONS.—

8 (A) IN GENERAL.—Each applicant against
9 whom adverse action is taken shall be entitled
10 to a statement of reasons for such action from
11 the surety.

12 (B) ACCEPTABLE FORMS OF STATE-
13 MENT.—A surety satisfies the requirement es-
14 tablished under subparagraph (A) by—

15 (i) providing a statement of reasons in
16 writing as a matter of course to applicants
17 against whom adverse action is taken; or

18 (ii) giving written notification of ad-
19 verse action which discloses—

20 (I) the applicant's right to a
21 statement of reasons within 30 days
22 after receipt by the surety of a re-
23 quest made within 60 days after such
24 notification; and

1 (II) the identity of the person or
2 office from which such statement may
3 be obtained.

4 (C) ORAL STATEMENT PERMITTED.—Such
5 statement may be given orally if the written no-
6 tification advises the applicant of the appli-
7 cant's right to have the statement of reasons
8 confirmed in writing on written request.

9 (3) SPECIFICITY OF REASONS.—A statement of
10 reasons meets the requirements of this Act only if
11 it contains specific reasons for the adverse action
12 taken.

13 (4) APPLICABILITY IN CASE OF 3D PARTY AP-
14 PPLICATIONS.—In the case of a request to a surety
15 by a third party to issue a bond directly or indirectly
16 to an applicant, the notification and statement of
17 reasons required by this section may be made di-
18 rectly by such surety, or indirectly through the third
19 party, if the identity of the surety is disclosed to the
20 applicant.

21 (5) APPLICABILITY IN CASE OF SURETIES
22 WHICH ACCEPT FEW APPLICATIONS.—The require-
23 ments of paragraph (2), (3), or (4) may be satisfied
24 by oral statements or notifications in the case of any
25 surety who did not act on more than 100 applica-

tions during the calendar year in which the adverse action is taken.

(e) ADVERSE ACTION DEFINED.—For purposes of this Act, the term “adverse action”—

(1) means a denial of a bond, a change in the terms of an existing bonding arrangement, or a refusal to issue a bond in the amount or on substantially the terms requested; and

(2) does not include any refusal to issue an additional bond under an existing bonding arrangement where the applicant is in default, or where such additional bond would exceed a previously established bonding limit.

SEC. 3. CIVIL LIABILITY.

(a) DAMAGES.—Any surety who fails to comply with section 2(a) shall be liable to the aggrieved applicant for—

(1) any actual damage sustained by such applicant (individually or as a member of a class); and

(2) in the case of any successful action under this section, the costs of the action, together with reasonable attorney’s fees as determined by the court.

(b) EQUITABLE RELIEF.—Upon application by an aggrieved applicant, a court of competent jurisdiction may enjoin a surety from violating the requirements of this Act

1 or grant such other equitable relief as the court deter-
2 mines to be appropriate to enforce such requirements.

3 (c) JURISDICTION.—Any action under this section
4 may be brought in any United States district court, or
5 in any other court of competent jurisdiction, within 1 year
6 after the date of the occurrence of the violation involved.

7 **SEC. 4. ADMINISTRATIVE ENFORCEMENT.**

8 (a) IN GENERAL.—A company may not be approved
9 as a surety by the Secretary of the Treasury under section
10 9304 of title 31, United States Code, or provide any surety
11 bond pursuant to such section unless such company main-
12 tains full compliance with the requirements of this Act.

13 (b) REQUIREMENTS RELATING TO ENFORCEABILITY
14 OF ACT.—

15 (1) SIGNED STATEMENT OF COMPLIANCE WITH
16 APPLICATION.—Section 9305(a) of title 31, United
17 States Code, is amended—

18 (A) by striking “and” at the end of para-
19 graph (1);

20 (B) by striking the period at the end of
21 paragraph (2) and inserting “; and”; and

22 (C) by adding at the end the following new
23 paragraph:

24 “(3) a statement of compliance with the Equal
25 Surety Bond Opportunity Act which is signed under

1 penalty of perjury by the president and the secretary
2 of the corporation.”.

3 (2) COMPLIANCE AS A CONDITION FOR AP-
4 PROVAL OF APPLICATION.—Section 9305(b) of title
5 31, United States Code, is amended—

6 (A) by striking “and” at the end of para-
7 graph (2);

8 (B) by striking the period at the end of
9 paragraph (3) and inserting “; and”; and

10 (C) by adding at the end the following new
11 paragraph:

12 “(4) the corporation is in full compliance with
13 the Equal Surety Bond Opportunity Act.”.

14 (3) SIGNED STATEMENT OF COMPLIANCE WITH
15 QUARTERLY REPORTS.—Section 9305(c) of title 31,
16 United States Code, is amended by inserting “and a
17 statement of compliance with the Equal Surety
18 Bond Opportunity Act” before the period.

19 (4) ENFORCEMENT AUTHORITY OF SECRETARY
20 OF THE TREASURY.—Section 9305(d) of title 31,
21 United States Code, is amended—

22 (A) in paragraph (1), by inserting “or the
23 provisions of the Equal Surety Bond Oppor-
24 tunity Act” before the semicolon;

1 (B) by striking “and” at the end of para-
2 graph (2);

3 (C) by striking the period at the end of
4 paragraph (3) and inserting “; and”; and

5 (D) by adding at the end the following new
6 paragraph:

7 “(4) may, after the end of the 1-year period be-
8 ginning on the effective date of any revocation under
9 paragraph (1) of the authority of a surety corpora-
10 tion for noncompliance with the Equal Surety Bond
11 Opportunity Act, reauthorize such corporation to
12 provide surety bonds under section 9304.”.

13 (5) REVOCATION FOR FAILURE TO PAY CER-
14 TAIN JUDGMENTS.—Section 9305(e) of title 31,
15 United States Code, is amended—

16 (A) by striking “and” at the end of para-
17 graph (1);

18 (B) by redesignating paragraph (2) as
19 paragraph (3); and

20 (C) by inserting after paragraph (1) the
21 following new paragraph:

22 “(2) the corporation does not pay a final judg-
23 ment or order against the corporation for noncompli-
24 ance with the Equal Surety Bond Opportunity Act

1 or fails to comply with any order under section 3(c)
2 of such Act;”.

3 (e) TECHNICAL AND CONFORMING AMENDMENT.—
4 Section 9304(a)(3) of title 31, United States Code, is
5 amended by inserting “and section 4(a) of the Equal Sur-
6 ety Bond Opportunity Act” before the period.

7 (d) REGULATIONS.—

8 (1) IN GENERAL.—The Secretary of the Treas-
9 ury shall prescribe such regulations as may be nec-
10 essary to carry out the purposes of this Act.

11 (2) INITIAL REGULATIONS.—The initial regula-
12 tions prescribed pursuant to paragraph (1) shall
13 take effect at the earliest practicable date after the
14 date of the enactment of this Act and not later than
15 the end of the 1-year period beginning on such date
16 of enactment.

17 **SEC. 5. EFFECTIVE DATE.**

18 Sections 2(d) and 4(a) shall take effect on the earlier
19 of—

20 (1) the effective date of the initial regulations
21 prescribed pursuant to section 4(d); or

22 (2) the end of the 1-year period beginning on
23 the date of the enactment of this Act.

Statement of the

American Subcontractors Association

before the

Subcommittee on
Minority Enterprise Development,
Finance, and Urban Development
Committee on Small Business
U.S. House of Representatives

on

Access to Surety Bonding

presented by

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July 20, 1993



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Statement on Access to Surety Bonding

The American Subcontractors Association (ASA) is a national trade association with more than 6,500 firms representing all major construction trades in 75 chapters. In addition to its individual company members, ASA represents 21 other specialty trade associations with members of their own.

Many ASA members perform construction for the federal government. Sometimes they serve as prime contractors, contracting directly with the government only through a prime contractor. These specialty trade contractors also contract with state and local governments, as well as private owners. Surety bonding is required on all federal construction contracts in excess of \$25,000, all federally-assisted contracts in excess of \$100,000, most other public construction (state as well as local), and increasing numbers of private construction projects. Thus, ASA members have a direct and real interest in surety bonding.

Generally, there are three types of bonds in construction: bid bonds, performance bonds and payment bonds. The bid bond states that the contractor will enter into a contract, if one is offered, and that it will furnish whatever additional bonds are specifically required. The performance bond assures the owner that the contractor will perform according to its contract. The payment bond assures the contractor's subcontractors and suppliers that they ultimately will be paid.

Surety bonding can mean life or death to a firm in the construction industry. The ability to get a contract may depend on the ability to get a bond. The ability to get a bond may depend on the adequacy of a bond. Failure to get work or failure to get paid for work performed, spells disaster for any firm.

ASA divides the problems with surety bonds into two general categories:

(1) the inability of some qualified contractors to get bonding; and

(2) the inadequate payment protection afforded subcontractors and suppliers by some payment bonds.

But the two issues are integrally related.

In recent years, there has been increasing discussion and controversy about the availability of surety bonds to contractors, particularly small, emerging, minority-owned and woman-owned firms.

A 1988 report by ASA's Special Task Force on Minorities and Women found that "access to surety bonds is a problem common to all subcontractors and a great source of frustration for them." But the ASA Task Force's preliminary research revealed that while there is a great deal of anecdotal data about the bonding access problem, there was very little statistical data

Today, there is a growing body of evidence that some contractors do, indeed, have limited access to surety bonds¹

¹ See Survey of Construction Subcontractors on Experience with Surety Bonding, American Subcontractors Association (1988); The Problems of Small and Minority Contractors in Obtaining Surety Bonds, The Center for Risk Management and Insurance Research, College of Business Administration, Georgia State University (1989); Experiences of Construction Specialty Trade Contractors with Surety Bonding: Two Surveys, Foundation of the American Subcontractors Association (1990); "Surety Credit for Construction Contractors: The Bond Producer's Perspective," Grant Thornton: Accountants and Management Consultants (1991); "Insights in Construction," Deloitte & Touche (1993); and various studies and reports by the National Association of Minority Contractors.

The 1990 surveys by the Foundation of the American Subcontractors Association generally revealed:

- an increased demand for surety bonding on both public and private work and at both the prime contractor and subcontractor levels;
- a surety market that is placing increasing demands on its contractor clients, through increased underwriting requirements and increased premiums -- and a reluctance by some contractors to meet those demands;
- a pattern of surety bond agents not providing their clients with needed information; and
- an underclass of principally small contractors who refuse to or are unable to provide surety bonds for a variety of reasons.

A 1991 Grant Thornton report confirmed that the trend toward tighter surety credit will continue. The Thornton report also indicated that "contractors can anticipate that more restrictions will be placed on them." Such restrictions include the method and form of financial presentations, increased disclosure of corporate and personal information, personal guarantees, geographic expansion and diversification.

As these trends continue, contractors must rely more heavily than ever on the advice and guidance of their surety agents. Indeed, the Thornton report noted, "As intermediaries between contractors and surety companies, surety agents and bond producers can often recommend ways for contractors to become more creditworthy."

Unfortunately, according to the 1990 FASA survey, contractors all too frequently received less service from their surety agents than might be considered desirable. Generally, specialty contractors who were ASA members reported receiving better service than non-ASA members. However, most contractors, particularly small and emerging firms, do not belong to associations.

The extent of the failure of the surety underwriting agency system to serve the needs of contractors is clearly demonstrated by the FASA survey. For example, when asked about the services provided by their surety agents, non-ASA members reported that:

- Only 43.3 percent of the agents provided positive advice useful in preparing material for submission to a surety;
- Only 29.9 percent explained surety underwriting criteria in advance of submitting the contractor's case to a surety;
- Only 23.9 advised the contractor of underwriting changes in advance; and
- Only 22.4 percent provided advance notice of rate increases.

Last year, Congress approved and the President signed the "Small Business Access to Surety Bond Survey Act."² That law requires the General Accounting Office to conduct a comprehensive survey of business firms, especially those owned by minorities and women, to determine their experiences with surety bonding. This GAO survey will provide important statistical information to the Congress as it determines the extent of the surety bond access problem and seeks solutions for it.

However, ASA believes that statistical data is only one piece of the puzzle. We believe that the Congress also needs to determine the impact that the inaccessibility of adequate surety credit has on otherwise qualified contractors. Congress also must explore a range of solutions to the problems identified. We commend this Subcommittee for conducting this hearing, a first step in achieving these two goals.

Already, there are many, both in the public and private sectors, struggling with the access issue. Many seem intent on identifying the solution to the problem. In ASA's opinion,

² Public Law 102-366.

however, there is not a single answer. Instead, both the private sector and the public sector must take a multitude of steps to solve the problem.

Education

First and foremost is education. There must be an ongoing public/private partnership dedicated to educating all the members of the surety team -- owners, contractors and sureties - about each other's problems and needs. An ostrich-style head-in-the-sand approach no longer will do. Instead, owners, including the federal government, must examine when surety bonding is necessary and use it only on those occasions, while taking steps to assure that subcontractors and suppliers have adequate payment protection when bonding is not used. Contractors must develop a greater understanding of the demands of suretyship and operate their businesses in a manner that develops their capacity for bonding. And, of course, the surety industry must understand there is, indeed, a problem -- for without that understanding and acceptance, the industry cannot be part of the solution.

While education may be the first step toward a solution to the "access problem," it cannot be the only step. Legislative and regulatory changes also must be made.

Equal Surety Bonding Opportunity Act

One of the key concerns about the surety bonding process expressed by the members of ASA's Task Force on Minorities and Women was the opportunity it presents for subjectivity. Both majority- and minority-owned subcontractors report a widespread feeling that surety decisions are subjective and arbitrary. ASA believes that more objectivity should be brought into the bonding process.

One of the recommendations of the ASA Task Force, ultimately approved by the ASA Board of Directors, was:

"ASA should seek legislation, similar to the Equal Credit Opportunity Act, to assure that all qualified contractors have access to surety bonds by requiring surety companies to notify a contractor of the reasons for a rejection of a bond application."

On February 16, 1990, ASA filed a petition for rulemaking (Attachment A) under section 553(e) of the Administrative Procedures Act, with the Fiscal Management Service of the U.S. Department of Treasury. That petition asked Treasury to incorporate in Part 223 of the Code of Federal Regulations, the concepts that are now embodied in H.R. 1464. Despite the requirement for a prompt response under Section 553(b) of the APA, Treasury responded to the ASA petition. Nor did Treasury respond to follow-up letters dated August 16, 1990 and September 27, 1990 (Attachments B and C).

Without the acknowledgement, let alone the cooperation of the Executive Branch, ASA turned to Congress. H.R. 1464, the "Equal Surety Bond Opportunity Act," introduced by Del. Eleanor Holmes Norton (D-D.C.), would:

- prohibit sureties from discriminating on the basis of race, color, religion, national origin, sex, marital status, sexual orientation, disability, or age (if the applicant has the ability to contract);
- prohibit sureties from discriminating because the applicant has obtained a bond through an individual surety or a special program designed to help small and emerging firms obtain surety bonding, or because an applicant has exercised his/her rights under this Act;
- require corporate surety firms that elect to seek approval by the U.S. Treasury Department in order to provide bonds on federal contracts to meet a higher standard, including:
 - requiring a surety or its agent to notify a contractor, within ten days of receipt of a completed application for a bond, or the action taken on its application for a bond;
 - entitling a contractor whose application for a bond has been rejected to a statement of reasons for such action from the surety or its agent.

Under the Miller Act, Congress essentially delegated to the surety industry the responsibility for determining whether a construction contractor is qualified to perform a given federal contract. That is, a surety, in practical terms, has assumed the responsibility for "prequalifying" a construction contractor on behalf of the federal contracting agency. ASA believes that a surety on federal contracts should undertake this responsibility with the same care and diligence, priorities and policies of the federal government.

Congress repeatedly has stated that it is the policy of the United States to assure that small businesses are given every opportunity to compete for federal procurement dollars. Indeed, there are many programs that give small and small disadvantaged businesses a preference in the bidding process for federal contracts.

Small businesses selling goods or services to the federal government have the right to appeal a contracting officer's finding of "non-responsibility." This appeals process is provided by the Small Business Administration pursuant to Section 8(b)(7) of the Small Business Act.³ Under the Certificate of Competency Program, a small business concern found to be otherwise eligible for an award which is found to be non-responsible by an agency contracting officer must have such a non-responsibility determination referred to the SBA. Upon application by the small business concern, SBA will review the qualifications of the small business concern to determine if it is a responsible source.⁴ If SBA finds the prospective contractor is capable of performing the contract in question, it awards the contractor a "Certificate of Competency." The federal contracting officer must accept this COC as confirmation of the contractor's

³ 15 U.S.C. 637(b)(7).

⁴ 41 U.S.C. 403(7).

responsibility and must make the award. The GAO has suggested that SBA's COC Program is successful because it permits small business concerns to understand and correct the deficiencies giving rise to the agency's initial concerns to affect necessary corrective action and are not merely "second-guessing" of the facts by SBA.⁵

Unfortunately, construction contractors have no opportunity to appeal the finding of a surety that it is "non-responsible" -- that is, it is not qualified to perform a contract on which it has chosen to bid. Indeed, the contractor may not even be told the reason why it was not granted a bond by the surety or its surety agent. Of the respondents to the 1990 FASA survey who were unable to obtain bonds, 41.2 percent reported that they received no explanation from the surety, despite an average of 3.2 applications.

In 1988, a representative of The Surety Association of America stated before a House subcommittee that:

"... being declined does not mean the contractor will be unable to get a bond in the future. The contractor is always free to take steps to fix whatever weaknesses are causing the bond availability problem. Except for serious character problems most weaknesses are curable if the contractor is willing to make the necessary effort."⁶

This is true, but only if the contractor is aware of what the surety perceives are its weaknesses.

ASA believes that H.R. 1464, the "Equal Surety Bond Opportunity Act," would provide contractors with the information tools critical to their success in obtaining adequate surety credit. The bill would provide a construction contractor denied a bond during the

⁵ General Accounting Office RCED-86-120BR.

⁶ Statement of Dennis E. Wine, Vice President, The Surety Association of America, to the Subcommittee on Commerce, Consumer Protection and Competitiveness of the House Committee on Energy and Commerce, June 29, 1988.

surety's prequalification process with the opportunity to make the changes in its firm necessary to allow it to perform the federal contract--an opportunity now provided to all prospective small business federal contractors when determined non-responsible by an agency contracting officer.

In order to assure that the sureties that are "prequalifying" contractors for federal contracts are themselves "prequalified" to perform that role, the U.S. Treasury requires such firms to meet certain financial and other standards. These standards are spelled out under Part 223 of the Code of Federal Regulations, governing "Surety Companies Doing Business with the United States." These requirements are not unlike standards set for other types of firms that elect to do business with the federal government.

The "Equal Surety Bond Opportunity Act" would add several requirements to this prequalification standard for surety companies that elect to do business with the federal government. These requirements are intended to assure that those businesses that a surety "prequalifies" on behalf of the government have access to all of the information tools they need to obtain the full amount of surety credit for which they are qualified. The new requirements proposed for surety companies that elect to do business with the federal government parallel almost exactly the requirements imposed on providers of consumer and certain types of business credit under the "Equal Credit Opportunity Act."

Certainly, it is a market decision for a surety company to determine that it does not want to bond certain types of contractors, whether that decision is based on the size of the contractor or the specialty trade of the contractor. However, when Congress passed the 1935 Miller Act, it did not require that bonds be provided only by large contractors; it provided

that all construction contractors, regardless of size or trade, provide a bond if the federal contract is over \$10,000 (later raised to \$25,000). Thus, ASA believes that surety firms that elect to do business with the federal government should be required to meet certain minimum standards, including those proposed under the "Equal Surety Bond Opportunity Act."

Representatives of surety companies have expressed concern about their ability to disclose such information through their agents. Their apparent concern is that they will be held liable for the failure of their agents to comply with the disclosure requirements.

However, ASA points out that the establishment of varying levels of trust and a resulting delegation of authority is the very foundation and nature of the agency system. Some companies grant certain agents a tremendous amount of authority, even to the point of giving them independent authority to approve millions of dollars worth of bonds.

In another example, some state laws require insurance companies to provide advance notice to their clients of rate increases for some insurance products. Some firms give this notice themselves; others rely on their agents to provide the notice. In either event, it is the company that is responsible for assuring that the notice is given and that is liable if it is not.

Some in the surety industry have expressed concern about the burdensome paperwork requirements they claim would be imposed by the disclosure requirements. ASA notes that contractors do not like unnecessary paperwork any more than those in the surety industry. Thus, the bill allows a surety to establish a system of notification of rights to the reasons for an adverse action on an application for a bond. Under this system, a surety would notify an applicant of its right to receive a written statement of the reasons for the denial. The

contractor then would have the right to request such a written explanation within an established period of time, if it so desires.

Others in the surety industry have expressed concern about being the object of libel suits by contractors. ASA points out that truth is the ultimate defense in such suits. And, if the surety has denied a contractor surety credit -- and, perhaps, the ability to survive in the construction industry -- on the basis of something less than the truth, it should be held responsible for such action.

As noted above, there is a significant amount of anecdotal data concerning discrimination in the granting of surety credit to minority- and women-owned firms. It is impossible for ASA to judge the qualifications of each of these contractors who allege such discrimination. However, the consistency and pattern of such reports lends credence to the existence of the problem.

Representatives of surety agents and producers have argued that it is against their financial interests to discriminate since their income is based on premiums received. However, ASA would note that these same income incentives are present in other forms of credit, where race and sex discrimination have been found to be prevalent. Studies on other forms of credit, for example, have found that:

- members of minority groups may receive unequal treatment in the prequalification stages (e.g., less time spent with the credit officer or cursory discussion of the credit products and alternative solutions for qualifying);
- underwriting guidelines, along with interpretation and application of the guidelines, were created based on historical data that primarily reflect nonminority credit seekers and therefore may be unintentionally racially biased; and
- minorities typically are not represented among the creditors' decisionmakers.

It is not unlikely that these same problems are present in the granting of surety credit.

Therefore, ASA supports the non-discrimination provisions of H.R. 1464.

It has been argued that these provisions are not necessary because discrimination in surety bonding is already illegal under the nation's basic civil rights laws. However, we believe that the clear definition of the scope of discrimination for surety credit is necessary, just as Congress has found it to be for other types of financial credit (i.e., Equal Credit Opportunity Act, Fair Housing Act, etc.).

Bond Waivers

During the last 15 years, Congress has enacted several programs that allowed the Small Business Administration to waive bonds under certain conditions. Such programs were never implemented.

Subcontractors and suppliers generally are opposed to any proposal that would limit or eliminate their protections under payment bonds. However, bond waivers may be acceptable if an alternative payment protection for subcontractors and suppliers is substituted for a payment bond, if/when the federal government is willing to forego the protection of the performance bond.

The most recent bond waiver program to be enacted was a pilot program incorporated into Section 301(b) of the "Business Opportunity Development Reform Act of 1988."⁷ That provision provides qualified 8(a) contractors with up to five exemptions from the bonding provisions of the Miller Act when certain requirements are met. The direct disbursement or escrow account alternative was set up as a four-year pilot program, which later was extended.

⁷ Public Law 100-656.

After enactment of the bond waiver program, several agencies expressed reluctance to identify projects under the 8(a) program on which the bonds could be waived. In addition, SBA appeared reluctant to implement the program. As a result, Senator Sam Nunn (D-Ga.) added a provision to the "National Defense Authorization Act for Fiscal Years 1990 and 1991,"⁸ that required each of the three military services to identify at least ten projects a year for this special program.

Nonetheless, the use of the surety bond waiver program has been limited.⁹ However, it should be noted that the contractors that have been awarded contracts with bond waivers have performed satisfactorily on those contracts. ASA hopes that the successful completion of contracts that use bond waivers, including payment of subcontractors and suppliers, will help establish credibility of the program and make it easier to get agencies to use bond waivers in the future.

The benefits of a program of bond waivers in conjunction with escrow accounts would be enjoyed by all participants in the construction process.

■ The general contractor would receive the opportunity to perform a federal construction contract for which it might not otherwise be eligible because of the bonding requirement. At the same time, the general contractor would lose none of its historic authority to approve subcontractor payments. Although the escrow agent must be paid if one is used, the fee is likely to be no higher than that for a bond. In addition, the general contractor can

⁸ Public Law 101-189.

⁹ ASA believes the limited use stems from SBA's poor implementation and from agency contracting officers' reluctance to let go of their "Linus blanket" of surety bonds.

avoid the time and expense involved in accounting for project funds and preparing checks without losing the ability to manage the job through requisition approval.

- The subcontractors and suppliers are assured that if the general contractor experiences financial or performance problems, funds paid to the general contractor by the agency for the subcontractor's work cannot be siphoned to remedy those problems. The use of an escrow account assures subcontractors that they will prompt receive both progress and final payments.

- The government agency will benefit from lower prices. Because the subcontractors are assured they will be paid, lower bids would be given to the general contractor and passed on to the agency before the job ever begins.

One drawback to the bond waiver program under the 8(a) Program is that the alternative payment protection provided only protects subcontractors at the first tier, unlike payment bond protections which flow down to the second tier. ASA believes that there are solutions to this problem, ranging from expansion of the escrow account operation to joint checks to a subcontractor and its sub-subcontractors and suppliers. If this problem can be solved, ASA believes it would be possible for the escrow account concept to be expanded beyond the 8(a) Program

Raising the Miller Act Threshold

A proposal closely aligned with bond waivers is the raising of the threshold for bonds under the Miller Act. This threshold currently is \$25,000, which comports with the small

purchase threshold for federal contracts. The final report of the so-called Section 800 Panel¹⁰ recommended that these thresholds be raised, along with more than 20 others.

ASA is opposed to raising the threshold for surety bonds under the Miller Act, unless alternative payment protections are provided for subcontractors and suppliers. The simple fact is that the payment bond provides the only protection for final payment currently available to subcontractors and suppliers. However, smaller contracts are particularly good targets for the use of alternatives to surety bonds, such as escrow accounts, direct disbursement, or joint checks.

Letters of Credit

ASA believes that, in some circumstances, an irrevocable letter of credit can be substituted for a surety bond, as long as the ILC is structured to provide adequate payment protection for subcontractors and suppliers.

On November 22, 1991, the Office of Federal Procurement Policy issued a policy letter allowing the use of ILCs in lieu of surety bonds for federal construction contracts.¹¹ OFPP set a sunset date of five years from the date of issuance of the Policy Letter.

However, nearly two years have passed and the Federal Acquisition Regulation Council has yet to incorporate the OFPP Policy Letter into the FAR. Once again, the federal agencies have ignored a directive to which they are opposed. ASA urges the Subcommittee to take action to assure prompt implementation of the OFPP Policy Letter, and, if necessary, extension of the sunset period.

¹⁰ "Streamlining Defense Acquisition Laws," Report of the Acquisition Law Advisory Committee, January 1993

¹¹ 56 Fed. Reg. 56932 (November 22, 1991). OFPP Policy Letter 91-4.

Small Business Administration Surety Bond Guarantee Program

ASA supports the strengthening and expansion of SBA's Surety Bond Guarantee Program as a partial solution to the "bonding access" problem. We also support the continuation of the "Preferred Surety Bond Guarantee Program, which was created by Title II of the "Small Business Administration Reauthorization and Amendment Act of 1988."¹² This Program was designed to encourage the standard corporate sureties to participate in the SBA Program.

While the 1988 amendments permit the SBA Program to assist more contractors, ASA believes still more can be done. For example, more contractors could participate in the Program if the size standard for participation in the Program were raised or if the maximum bond size were increased. Congress should explore these options.

However, the assistance provided by the SBA Program is illusory if contractors are not aware of its existence. ASA recommends that the government's solicitations for contracts with a bonding requirement be annotated with a notice about the availability of the SBA Program.

In addition, ASA believes that Congress soon will have to authorize and appropriate additional funding for the SBA Program. In the past, the Program ran out of funds at the end of its fiscal year. This discouraged some surety agents from placing prospective clients in the Program. It is true that the Program's funding has been sufficient during the last few years, largely because of the deep recession in the construction industry. However, as the industry recovers, the demands on the SBA Program will increase.

¹² Public Law 100-590.

Other Solutions to the Surety Bond Access Problem

The proposals discussed above are not the only solutions to the bonding access problem. ASA is exploring other ideas, including allowing banks to provide surety credit. Surely other potential solutions will be identified as the discussions continue.

Inadequate Payment Bond Protections

As noted above, an integral part of the bonding issue is the inadequate protections provided to subcontractors and suppliers under some payment bonds. One of the most serious problems facing subcontractors and suppliers on federal construction is the inability to get paid for work performed if a contractor defaults.

The fundamental need of subcontractors and suppliers who furnish labor and materials to a construction project to be paid has long been recognized. In order to protect subcontractors and suppliers, the various states have enacted lien laws to secure a certain priority of payment and thereby aid in the collection of sums due for services rendered on private construction projects. However, public property, in effect owned by the people, may not be liened.

Congress recognized this dilemma when it enacted the Miller Act in 1935. At the time of enactment and later amendment, the Miller Act was considered a good law and, up to a point, it has been. But the protections afforded subcontractors under the Miller Act today often are illusory. ASA has long supported wide-ranging amendments to the Miller Act. These proposed amendments include:

(1) Requiring the payment bond to equal the performance bond. Under the Miller Act, the Government is protected by a performance bond in an amount the contracting officer "deems adequate for the protection of the United States." That amount usually is 100 percent.

Subcontractors, however, are protected by a payment bond which is only one-half of the contract amount if the contract is less than \$1 million; 40 percent of the contract amount if the contract is between \$1 million and \$5 million; and a \$2.5 million maximum if the contract is for more than \$5 million

A 1975 General Accounting Office study concluded:

"The Miller Act should be amended to permit the Federal agencies to furnish 100 percent payment bonds as long as rate schedules provide no appreciable rate reduction for less than 100-percent coverage. The current reductions on payment bonds produce reduced protection with little or no savings in premium costs."¹³

The maximum dollar protection for a subcontractor under the Miller Act has been severely eroded by inflation. In any event, ASA believes that subcontractors deserve protection in an amount equal to that of the government. Thus, ASA supports an amendment to the Miller Act to require that a payment bond equal the performance on a Miller Act project.

(2) Extending liability to the Government if its agent fails to assure that a proper payment bond is in place. In the event that a Miller Act bond is not posted by the prime contractor, the contract is voidable and can be terminated by the government at its option. If the government does not terminate the contract, and the contractor defaults, the claimant has no standing to sue the government for payment since it is not in privity with the government. As stated by the U.S. Court of Appeals for the Seventh Circuit:

"The result is . . . unjust. A subcontractor who fulfills his part of the bargain should not suffer because the prime contractor defaulted, and the government contracting officer had not insisted on compliance with the Miller Act. We agree that there is a practical problem . . . that is not addressed by the Miller Act, but that is a problem that can only be addressed, and redressed, by Congress."

¹³ General Accounting Office LCD-74-319.

ASA supports an amendment to the Miller Act to place an affirmative obligation on the government to assure prime contractor compliance with the Miller Act. Under such a provision, the government would be liable to the subcontractor if the contracting officer fails to assure that the prime contractor provided a suitable bond. ASA believes it is wrong -- and an abrogation of congressional intent -- for a subcontractor to suffer a financial loss because of the government's failure to enforce the Miller Act.

(3) Prohibiting the waiver of rights under the payment bond. Some agreements between a general contractor and subcontractor require the subcontractor to waive, directly or indirectly, its rights under the Miller Act. Such subcontract provisions are designed to protect the general contractor and its surety by providing them with defenses on a bonded job. ASA supports legislation to nullify any contract provision that would directly or indirectly waive a subcontractor's rights under the Miller Act. Given the uneven negotiating power between a general contractor and a subcontractor, ASA believes that such provisions -- which operate to the legal and practical detriment of the subcontractor -- should be against public policy.

(4) Permitting the award of attorneys' fees and interest to a successful claimant. Many assume that a prime contractor or its surety settles payment claims upon receipt of notice and after investigation of the merits and validity of the claim. However, ASA receives many complaints from unpaid subcontractors that a surety's disclaimer, failure to respond, or other act has demonstrated that it is necessary to resort to actual court action in order to secure the satisfaction of the claim. In some cases, the claimant is reluctant to initiate litigation because it is clear that the legal and court costs will be so high in proportion to the amount that could be recovered as to constitute an effective legal barrier to the very protection that Congress has statutorily prescribed.

Thus, the payment bond protection afforded by the Miller Act has operated unevenly. For large firms that take on sizable subcontracts and whose claims may be sufficiently large to permit litigation, the bonds offer the protection intended. For those whose claims are small, and who most often are very small firms, the protection is not available from a practical standpoint.

(5) Allow notice to a prime contractor by any method that provides sufficient proof of receipt. The Miller Act requires certain subcontractors and suppliers -- those who do not have a direct contractual relationship with the prime contractor -- to provide written notice to the prime contractor that they intend to institute action under the Miller Act. That notice must be given by "registered mail." Although most courts have excused this requirement when it has been shown that a prime contractor actually received notice, it still may provide the general contractor and its surety with a technical defense to an otherwise recoverable Miller Act suit. ASA supports legislation to amend the Miller Act to allow notice to be sent by any method that provides sufficient proof of receipt.

(6) Defining the notice as timely if the subcontractor sends it within the 90-day notice period. At least one court has ruled that the subcontractor's notice is timely only if the prime contractor receives it within the 90-day notice period. Once the subcontractor turns its notice over to the U.S. Postal Service for delivery by "registered mail," it no longer can control the timing of delivery. So, no matter how early the subcontractor sends the proper notice, it has no guarantee that it will be received by the general contractor in a timely manner, given the statutorily-mandated delivery method. Thus, ASA supports an amendment to the Miller Act defining that notice as timely if the subcontractor sends it within the 90-day notice period.

(7) Allowing a claimant to provide notice at any time prior to 90 days after furnishing labor or materials. Some courts have ruled that notice given before the actual final day of work was premature and therefore dismissed the suit. These court rulings provide the general contractor and its surety with a technical defense to an otherwise recoverable Miller Act suit. ASA recommends that the Miller Act be amended to require notice "not later than 90 days" (rather than "within 90 days") from the date of last furnishing.

(8) Allowing the filing of suit upon the denial of a claim. The Miller Act requires a claimant to wait 90 days after it last performs labor or furnishes material on the project before filing suit. Although most courts have excused this requirement, it still may provide a surety with a technical defense to an otherwise recoverable Miller Act suit. ASA recommends that the Miller Act be amended to allow waiver of the 90-day waiting period provided the subcontractor has received a denial of its claim from the general contractor. ASA believes that there is no reason to require a subcontractor to wait 90 days when it knows that payment will not be forthcoming during that period.

(9) Allowing the filing of a suit up to one-year after anyone has furnished labor or material on a project. The Miller Act requires a subcontractor to file suit within one year from its last date of furnishing labor or material on a project. This is a serious problem, particularly for "early finishing" trades on projects where funds are retained. For example, a subcontractor whose work may be completed during the first few months of a two- or three-year project, may have its final payment delayed for several years beyond its completion date. If it files suit within the one-year, the prime contractor and the surety may defend on the ground that the money is not yet due. If the subcontractor waits beyond the one year, it loses all rights

under the Miller Act. ASA recommends that the Miller Act be amended to allow the filing of suit up to one-year after anyone has furnished labor or material on the project.

(10) Extending the protections of the Miller Act to progress payments. Under the Miller Act, a subcontractor may not file suit under the payment bond until it has been off the job for 90 days. Thus, a subcontractor has no right under the Miller Act to assure the receipt of periodic progress payments. This problem is exacerbated by terms, frequently found in subcontracts, that prohibit a subcontractor from stopping work because of nonpayment. Thus, on a large job of lengthy duration, a subcontractor could be forced to work for months or even years without receiving payment, and have no recourse until the job is completed. Therefore, ASA supports an amendment to the Miller Act that would extend the protections of the Act to progress payments.

(11) Extending protections of the Act to lower tiers. Coverage under the Miller Act and hence the right to bring an action under the contractor's Miller Act bond extends to those in direct contractual relationship with the prime contractor. The right to sue and recover under the Miller Act thus extends no further than the supplier to a subcontractor and second-tier subcontractor (a sub-subcontractor), because these are the only entities with a direct contractual relationship with a subcontractor of the prime contractor. Yet there may be multiple tiers of subcontractors on a federal construction project. This has become increasingly likely with the advent of the increased use of contract bundling, construction management, general contractors that do no part of the actual construction themselves, and increased specialization in construction. ASA supports legislation to amend the Miller Act to extend the protections of the Act to all on-site subcontractors and their suppliers.

Summary

ASA believes that it is time for Congress to address the twin problems of:

- (1) the inability of some qualified contractors to get adequate bonding; and
- (2) the inadequate payment protection afforded subcontractors and suppliers by some

payment bonds.

ASA commends this Subcommittee for taking an important step to resolving these problems.

ASA believes that there is no single solution to the surety bond access problem.

However, an important first step is enactment of H.R. 1464, the "Equal Surety Bond Opportunity Act." Other possible solutions include the use of bond waivers when subcontractors are provided with alternative payment protection; irrevocable letters of credit in lieu of bonds, and expansion of the SBA Surety Bond Guarantee Program.

In addition, ASA recommends that Congress amend the Miller Act to improve payment protections to construction subcontractors and suppliers.

ASA looks forward to continue to work with the Subcommittee on the important issue of surety bonding.



February 16, 1990

Commissioner William E. Douglas
Financial Management Service
U.S. Department of the Treasury
Liberty Center
401 14th Street, S.W.
Washington, D.C. 20227

Dear Commissioner Douglas:

(1) Pursuant to Section 553(e) of the Administrative Procedures Act, the American Subcontractors Association (ASA) petitions for a rulemaking to amend Part 223 of the Code of Federal Regulations, governing "Surety Companies Doing Business With the United States." ASA petitions that the regulation be amended to:

- make it unlawful for a Treasury-approved surety to discriminate against any applicant on the basis of race, color, religion, national origin or sex or marital status;
- require such a surety or its agent to notify an applicant for a bond of the action on an application within a time period designated by the applicant if that time is considered reasonable or a longer period that comports with prevailing industry practice; and
- entitle an applicant for a bond whose application has been denied, to receive, upon request, a written statement of reasons for such action from such surety or its agent.

(2) ASA is a national association with more than 8,000 member firms in nearly every construction specialty trade. In addition, ASA represents 20 national associations of specialty trade contractors with members of their own (See Attachment A). Many ASA members serve as prime contractors on federal construction. Thus, ASA has a real and direct interest in any law or regulation that impacts the ability of construction contractors to do business with the federal government.

(3) The 1935 Miller Act requires federal construction contractors with contracts over \$25,000 to provide performance and payment bonds. The Federal Acquisition Regulation provides that if a prime contractor provides a corporate surety bond, the surety company providing that bond must be listed in Department

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Circular No. 570, "Companies Holding Certificates of Authority as Acceptable Sureties on Federal Bonds and as Acceptable Reinsuring Companies."

In the Miller Act, Congress essentially delegated to the surety industry the responsibility for determining whether a construction contractor is qualified to perform a given federal contract. That is, a surety, in practical terms, has assumed the responsibility for "prequalifying" a construction contractor on behalf of the federal contracting agency. Thus, ASA believes that a surety approved by the Treasury Department to provide bonds on federal contracts should undertake this responsibility with the same care, diligence, priorities and policies of the federal government.

(4) Congress repeatedly has stated that it is the policy of the United States to assure that small businesses and small disadvantaged businesses are given every opportunity to compete for federal procurement dollars. Indeed, there are many programs that give small businesses and small disadvantaged businesses a preference in the bidding process for federal contracts.

Yet, complaints about the surety bond process are particularly prevalent from minority-owned and woman-owned businesses. Many of the owners of these firms believe that the reason for their denial of a bond is race or sex discrimination. Yet, it can be acknowledged that because of historical patterns, minority- and woman-owned firms are more likely to be small and relatively new. These are just the type of firms to which many surety companies are reluctant to provide bonds. In addition, because of government preference programs, minority- and woman-owned firms are more likely to be participating in government procurement for which they must provide bonds.

The extent of any discrimination specifically against minority and woman-owned businesses may be difficult to prove. But whether such discrimination actually exists or not, surety companies providing bonds for federal procurement should be specifically prohibited from discriminating on the basis of race, color, religion, national origin, or sex or marital status.

(5) Small businesses selling goods or services, including construction, to the federal government have the right to appeal a contracting officer's finding of "non-responsibility." This appeals process is provided by the Small Business Administration pursuant to Section 8(b)(7) of the Small Business Act (15 U.S.C. 637(b)(7)). Under the Certificate of Competency Program, a small business concern found to be otherwise eligible for award which

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is found to be non-responsible by an agency contracting officer must have such a non-responsibility determination referred to the SBA. Upon application by the small business concern, SBA will review the qualifications of the small business concern to determine if it is a responsible source (41 U.S.C. 403(7)). If SBA finds the prospective contractor is capable of performing the contract in question, it awards the contractor a "Certificate of Competency." The federal contracting officer must accept this COC as confirmation of the contractor's responsibility and must make the award. A recent General Accounting Office Report (RCED-86-120BR) suggests that SBA's COC Program is successful because it permits small business concerns to understand and correct the deficiencies giving rise to the agency's initial non-responsibility determination. A finding of the Report is that COC's reflect the ability of small business concerns to affect necessary corrective action and are not merely "second-guessing" of the facts by SBA.

Construction contractors have no opportunity to appeal the finding of a surety that it is "non-responsible"--that is, it is not qualified to perform a contract on which it has chosen to bid. Indeed, the contractor may not even be told the reason why it was not granted a bond by the surety or its agent.

In 1988, a representative of The Surety Association of America stated before a House subcommittee that:

" . . . being declined does not mean the contractor will be unable to get a bond in the future. The contractor is always free to take steps to fix whatever weaknesses are causing the bond availability problem. Except for serious character problems most weaknesses are curable if the contractor is willing to make the necessary effort."
(Statement of Dennis E. Wine, Vice President, The Surety Association of America, to the Subcommittee on Commerce, Consumer Protection and Competitiveness of the House Committee on Energy and Commerce, June 29, 1988.)

This is true, but only if the contractor is aware of what the surety perceives are its weaknesses.

The ASA recommended amendment to Treasury's regulations would provide a construction contractor denied a bond during the surety's prequalification process with the opportunity to make the changes in its firm necessary to allow it to perform the federal contract--an opportunity now provided to all prospective small business federal contractors when determined non-responsible by an agency contracting officer.

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Page Four

(6) ASA has received increasing numbers of reports from contractors who say they are qualified to perform a given contract but are unable to obtain a bond for the contract. While it is impossible for ASA to judge the qualifications of each of these contractors, they tend to have one thing in common: they are small firms that seldom need to provide bonds or need to provide bonds in only small amounts. Again, these are just the type of firms for which many surety companies are less than eager to provide surety bonds.

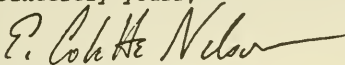
Certainly, it is a market decision for a surety company to determine that it does not want to bond certain types of contractors, whether that decision is based on the size of the contractor or the specialty trade of the contractor. However, when Congress passed the 1935 Miller Act--for practical purposes, establishing the surety industry in the United States--it did not require that bonds be provided only by large contractors or by general contractors; it provided that all construction contractors, regardless of size or trade, provide a bond if the federal contract is over \$10,000 (later raised to \$25,000). A surety company that has been approved to provide bonds on federal procurement should provide bonds to any contractor qualified to perform a specific federal contract--not just those who conveniently fit the surety's marketing niche or provide the largest premium income.

The amendment to the Treasury regulations proposed by ASA would help assure that the companies approved by Treasury recognize the seriousness of the responsibilities delegated to them by Congress under the Miller Act.

(7) Pursuant to Section 555(b) of the Administrative Procedures Act, we look forward to a prompt resolution of this petition for rulemaking and publication of a Notice of Proposed Rulemaking incorporating these essential modifications into the existing regulations.

If there is anything that ASA can do to help expedite your consideration of this petition, please do not hesitate to contact us.

Sincerely yours,



E. Colette Nelson
Vice President of Government Relations

Attachment B



August 16, 1990

Commissioner William E. Douglas
Financial Management Service
U.S. Department of the Treasury
Liberty Center
401 14th Street, S.W.
Washington, D.C. 20227

Dear Commissioner Douglas:

Six months ago, on February 16, 1990, the American Subcontractors Association submitted to you a petition for proposed rulemaking pursuant to the Administrative Procedures Act (5 U.S.C. Sec. 553(e)). That petition made specific recommendations concerning amendment to Part 223 of the Code of Federal Regulations, governing "Surety Companies Doing Business with the United States." A copy of that petition for rulemaking is attached.

Would you please give us an indication of when ASA can expect a formal response to its petition. We note that the APA (5 U.S.C. Sect. 555(e)) requires that agencies conclude matters submitted to them within a reasonable amount of time.

We will look forward to your prompt response.

Sincerely,

E. Colette Nelson
Vice President of Government Relations

Enclosure

cc w/encl.: Terry Boyer
Manager, Surety Bond Branch

AMERICAN SUBCONTRACTORS ASSOCIATION, INC.
1004 DUKE STREET, ALEXANDRIA, VA 22314-3512
(703) 684-3450

Attachment C



September 27, 1990

Ms. Terry Boyer
Manager, Surety Bonds Branch
Financial Management Service
U.S. Department of the Treasury
Liberty Center
401 14th Street, S.W.
Washington, D.C. 20227

Dear Terry:

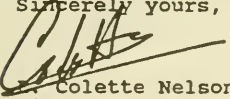
Last week, representatives of the American Subcontractors Association met with representatives of The Surety Association of America and the National Association of Surety Bond Producers. During that meeting, SAA President Lloyd Provost expressed concern about the petition of rulemaking that ASA submitted to Commissioner Douglas on February 16, 1990. Mr. Provost said that SAA had reviewed the petition, a copy of which he had obtained from your office, and is opposed to its consideration.

While we do not question your right to provide Mr. Provost with a copy of the ASA petition or even to discuss it with him, we are concerned that such discussions have been undertaken when we have not been able to get a response to our letters on the subject. Indeed, recently, my phone calls have not been returned.

I have been informed by a staff member in the Office of Federal Procurement Policy that "Treasury is opposed to the ASA proposal." We would hope that Treasury's opposition does not result in the denial of any response at all.

Terry, I urge you to take steps to formally respond to the ASA petition of rulemaking dated February 16, 1990 (copy enclosed). If there is anything that ASA can do to help expedite consideration of this petition, please do not hesitate to contact me.

Sincerely yours,


Colette Nelson

Vice President of Government Relations

Enclosure

cc w/encl.: Commissioner William E. Douglas

AMERICAN SUBCONTRACTORS ASSOCIATION, INC.
1004 DUKE STREET, ALEXANDRIA, VA 22314-3512
(703) 684-3450



**National Association of
Surety Bond Producers**

5301 Wisconsin Avenue, NW, Suite 450
Washington, DC 20015-2015
(202) 686-3700 • FAX (202) 686-3656

STATEMENT OF
J. MARTIN HUBER
EXECUTIVE VICE PRESIDENT OF THE
NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS
WASHINGTON, D.C.

BEFORE THE
HOUSE SMALL BUSINESS COMMITTEE,
SUBCOMMITTEE ON
MINORITY ENTERPRISE, FINANCE AND URBAN DEVELOPMENT

REGARDING
ACCESS TO SURETY BONDING FOR SMALL, MINORITY
AND WOMEN-OWNED CONTRACTING FIRMS

JULY 20, 1993

Thank you Chairman Mfume for holding this hearing on a subject of mutual interest to the surety industry and small, minority and women-owned contractors. I also want to thank you for the balanced approach you have taken in structuring this hearing -- it is an important subject that deserves the attention you are giving it.

I am very pleased to testify before the subcommittee today on the issue of access to surety bonds for small, minority and women-owned contractors. The National Association of Surety Bond Producers (NASBP) is an organization of some 560 agencies and brokerage firms that are recognized as specialists in surety bonding and insurance for construction contractors.

Our testimony will deal with the areas that you have specifically asked us to cover; namely, the types of counseling rendered contractors by NASBP members, the process for prequalifying small, minority and women-owned contracting firms for surety credit, and the ways in which Congress can eliminate or prohibit discrimination in surety bonding.

The Surety Prequalification Process, and
How Professional Surety Producers Assist Small,
Minority and Women-Owned Construction Firms

Most companies that issue surety bonds work through agents and brokers, also known as producers since they "produce" the business for the surety bond companies. Many NASBP members have worked as surety company underwriters or branch office representatives before becoming a surety producer. Most have extensive experience with construction contractors, and think of themselves more as a part of the construction industry rather than of the insurance industry.

NASBP members often are called upon to guide small, minority and women-owned contractors through the bonding prequalification process. Contractors who are establishing their initial relationship with a surety company will find that it is necessary to spend a considerable amount of time and effort with their surety producer assembling this first submission to a surety company. The surety underwriting process is focused on prequalifying the contractor for the particular job in question. However, the surety underwriter needs to know about all of the projects the contractor has underway in order to evaluate the firm's ability to take on the additional project.

The information that the surety company wants to see in this submission is needed so that the surety underwriter can satisfy herself that the contracting firm is a well-managed, profitable enterprise which keeps promises, deals fairly and performs obligations in a timely manner.

Each surety bond company has its own standards and requirements. The surety producer represents several surety bond companies, and knows the differing underwriting standards of each. It is the producer's job to match the contractor with the surety bond company whose underwriting criteria best fit the particular contractor. While surety bond company standards differ, there are fundamental kinds of information that most surety bond companies will want in a submission from a contractor -- especially a first-time submission.

The surety bond company's underwriter will want to see an organization chart that shows the contracting firm's key employees and their responsibilities. Detailed resumes of the key people in the company also will be needed. The underwriter would like the contractor to have a business plan outlining the type of work the firm does, how it obtains jobs, and the growth and profit objectives of the company.

The contractor will likely be asked for a plan on how the business would continue in the event of the death or disablement of a key person in the firm. Of course, subcontractor and supplier references will be requested to demonstrate the

contractor's history of paying those to whom he or she owes money. Most likely, the underwriter will ask for evidence of a bank line of credit that can be used to meet short-term cash requirements. Letters of recommendation from owners, architects and engineers would help bolster the contractor's submission.

Financial information is vital to any business that is granting credit, and surety bond companies are no exception. Depending on how long the contracting firm has been in business, the surety underwriter will want to see fiscal year-end statements for the past three to five years. While surety bond companies prefer CPA audited financial statements, most would accept review statements from smaller contracting firms. Complete and accurate cost recording and accounting systems are extremely important to surety bond companies -- as they should be to contractors. Without these systems, a contractor likely will not be able to identify and correct problems before they become too severe. Integral to this cost recording system is a schedule of work-in-progress that should be updated on a quarterly basis.

A knowledgeable surety producer can help small, minority and women-owned contractors overcome the problem of weak or marginal information in one of these areas by emphasizing strengths in another. The producer knows which of his surety companies, for example, place heavy emphasis on financial information; which may give more weight to experience; which are prefer bonding excavation contractors as opposed to builders; and which welcome

smaller contracting firms or even those with infrequent surety needs. The contractor's surety producer will, in effect, "pre-underwrite" the contractor and help "package" the submission in the way most likely to be acceptable to a particular surety company.

The producer is responsible for keeping the contractor and the surety informed of all matters that may influence the bonding relationship. The producers's ultimate objective is to be as responsive as possible to the contractor while assisting the contractor in providing the surety underwriter with all of the information needed for the underwriter to reach, hopefully, an affirmative decision.

Each small, minority and women-owned contractor will have a different way of developing the information necessary to make the day-to-day and long-term decisions involved in running his or her company. But all contractors need the counsel and guidance of professionals in other fields if they are going to be successful. These professionals, who can be looked upon by the contractor as his or her unofficial "board of directors", should include an accountant, preferably a CPA who specializes in the construction industry; an attorney familiar with contracting; a banker who can provide a line of credit as well as credit advice and the surety bond producer who brings to the contractor not only the requirements for obtaining surety bonds, but the professional experience of working with many different kinds of contractors and knowing what makes some succeed and some fail.

NASBP members take great pride in the role they play in aiding small, minority and women-owned contractors in their growth and development.

Ways Congress Can Eliminate or Prohibit Discrimination In Surety Bonding

There are currently two bills before the House of Representatives dealing with minority and women-owned business access to surety bonding, both of which NASBP supports.

The first is Chairman Kweisi Mfume's legislation, H.R.278, that would upgrade the Department of Commerce's Minority Business Development Agency to the Minority Business Development Administration. NASBP fully supports this legislation, especially its goal of making management and technological assistance available to disadvantaged businesses. Further, we stand ready to help in the establishment of a surety bond referral assistance program called for in Section 202 of this bill.

NASBP is unequivocally opposed to discrimination in surety bonding based on race, color, religion, national origin, sex, marital status, sexual orientation, disability or age. We support, therefore, the provisions of Congresswoman Eleanor Holmes Norton's legislation, H.R. 1464, that prohibit such discrimination.

H.R. 1464 further requires surety underwriters and agents to provide to any contractor for whom it is unable or unwilling to provide surety bonds the reasons why it will not provide such bonds. Again, NASBP supports this as a fundamental right. In fact, NASBP members -- producers specializing in the construction industry -- not only give reasons, but counsel the contractor on what changes he or she needs to make in their operations or business practices in order to qualify for surety credit.

NASBP fully supports these key provisions of H.R. 1464. There are some technical changes that we have recommended to Mrs. Norton that will make the bill more workable, and I am sure these can be worked out.

Another important thing that Congress can do to enhance minority, women-owned and emerging contractor access to the surety bonding market is to support the U.S. Small Business Administration's Surety Bond Guarantee (SBG) Programs. There are two such programs which, through a U.S. Government guarantee of a portion of potential losses, enable surety companies to issue bonds for contractors who may not meet all of the companies' normal underwriting standards.

While many NASBP members participate in the original prior-approval SBG program, it is the newer, Preferred SBG program that is of real interest to NASBP's members and the standard surety companies which they represent. The SBA assistant administrator in charge of these programs, Dorothy Kleeschulte, reports that fully 25 percent of the bonds

guaranteed in the Preferred SBG program have been written for minority contractors.

Finally, the results of a recent survey of NASBP members indicate that the surety industry is, in fact, writing bonds for qualified minority and women-owned contractors. One hundred and twelve corporate surety companies were identified by NASBP agents and brokers as actively writing bonds for small contractors. Surety bond companies were identified in every state, the District of Columbia and Puerto Rico.

Further, the 50 percent of NASBP's members who responded to the survey successfully assisted some 7,912 small contracting firms with their surety bonding needs during the past twelve months. Thirteen percent of these 7,912 were minority-owned firms, and seven percent were women-owned. Of the 2,481 of these firms that were seeking their first-ever surety bond, 17 percent were minority-owned and 12 percent were women-owned.

This list of 112 surety markets for small contractor bonds includes most of the major surety bond companies in this country, many of which have established special small contractor units to handle these accounts efficiently. Also on the list are new companies that have entered the surety business specifically targeting the small contractor market segment. In fact, in a series of interviews that NASBP conducted with surety company executives this year, the observation heard more than once was that the small contractor surety marketplace was "overcrowded", and that the competition was extremely vigorous.

Does this mean that every contractor who may want a surety bond will be successful in getting one? Probably not. First of all, the contractor who has never before had a bond needs to access the surety marketplace. The contractor cannot approach surety companies directly, but must go through an agent or broker. While there are some 40,000 insurance agencies in the country whose state insurance licenses allow them to produce surety bonds, very few of these 40,000 are surety bond specialists. Many of those who do specialize in bonding and insurance for contractors are members of NASBP.

Through liaisons with numerous construction industry organizations including the National Association of Minority Contractors, the National Association of Women in Construction, the American Subcontractors Associations, Women Construction Owners and Executives USA and others, NASBP is making itself and its members known to the contractors who need bonds.

Will every contractor who wants a bond and who finds his or her way to a professional agent or broker get a bond? Probably not. There is a fundamental mixture of business acumen, construction experience, financial where-with-all and ability to weather the many misfortunes that regularly befall construction projects that must be present if surety credit is to be extended. That mixture will vary from surety company to surety company. But, even in this current most competitive marketplace for small contractor surety bonds, there will be contractors who think they should have bonds and who will not be able to get them.

The solution for those who do not qualify for surety credit is almost always education and counseling. That is what the professional surety bond producer is qualified to do. Throughout the country, NASBP members conduct and participate in seminars and workshops, speak at subcontractor and small contractor association meetings, counsel contractors on an individual basis and, in many other ways, educate smaller contractors on how to qualify for surety bonds, but more importantly, on how to become profitable, viable contracting firms.

NASBP member bond producers make no fee unless bonds are actually written. Unlike the increasing number of surety "consultants" who charge a fee before they offer their advice or assistance (and whose bonding "solution" is often an unlicensed, unverifiable off-shore entity), NASBP members' incentive is to qualify the contractor for surety credit in legitimate surety companies so that bonds will be written and commissions earned. Helping small, emerging contractors grow into large profitable firms creates the most loyal customers for the surety producer. NASBP members are in business for the long term, and that is clearly what they want for their contractor customers.

NASBP thanks Chairman Mfume, the subcommittee and the very professional staff for the opportunity to present our views on this important issue.



NATIONAL ASSOCIATION OF MINORITY CONTRACTORS

1333 F Street, N.W. • Suite 500 • Washington, D.C. 20004 • (202) 347-8259

TESTIMONY OF THE

NATIONAL ASSOCIATION OF MINORITY CONTRACTORS

before the

**U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON MINORITY ENTERPRISE, FINANCE AND URBAN
DEVELOPMENT**

**Regarding Access to Surety Bonding by Qualified
Small and Minority Contractors**

by

**Samuel A. Carradine, Jr.
Executive Director**

July 20, 1993

Good morning, Mr. Chairman and honorable members. My name is Samuel Carradine, and I am the Executive Director of the National Association of Minority Contractors (NAMC). Established in 1969 and headquartered in Washington, D.C., the National Association of Minority Contractors or NAMC, is a full-service association which represents the interests of the nation's minority contractors. On behalf of these contractors, NAMC would like to thank the Subcommittee for holding this hearing and examining the issues which affect the access to surety bonding by qualified small, minority and female-owned construction firms.

It is with extreme regret that NAMC must agree with the constantly-repeated assertion that bonding difficulties constitute the most severe obstacle to equitable participation in public construction projects by qualified minority, small and female contractors. Moreover, with the possible exception of the acquisition of initial bonds (often under potentially harmful arrangements), the obstacles presented by inordinate bonding difficulties are not diminishing for these contractors.

The great importance of our members' access to contract bonds has prompted NAMC to devote enormous time and effort to bonding issues. We have monitored the extent and nature of their bonding problems through a number of efforts, including:

- conducting surveys
- conducting research projects

- noting the specific problems reported by individual contractors, and
- Tracking the actions of surety companies and producers in responding to requests for bonds by minority contractors

Through these efforts, we continue to find that minority contractors who are qualified to perform public projects encounter bonding problems far more frequently than non-minority contractors. These bond problems may be attributable to the following causes:

1. **Historical Discrimination** - This country's record of pervasive and persistent institutional discrimination has placed minority contractors in positions of disadvantage in capital acquisition, financing procurement, and many other areas which are related to their abilities (or inabilities) to obtain satisfactory bond arrangements. Ironically, the discrimination they face in seeking private jobs leads many minority contractors to turn to public jobs - the very jobs for which bonds are usually required.
2. **The Disparate Effect of Surety Underwriting Standards** - Surety underwriting standards which may not be designed to discriminate specifically against minority contractors can create larger barriers for minority contractors. For example, standards which discourage bonds for small contractors or subcontractors usually affect a greater proportion of minority contractors because relatively large percentages of minority contractors are "small" and are subcontractors.

3. **Deliberate and subconscious discrimination by parties in the surety industry** - Often, a favorable final response to a request for bonding depends on positive reactions and enthusiastic advocacy actions by several parties - the producer, the local underwriter, the bond manager, and headquarters offices. A discriminatory act by any one party can easily bring about a declination.
4. **The Inadequacy of Bond Assistance Programs** - For a variety of reasons including the lack of technical surety expertise, inappropriate approaches, and ineffective implementation steps, minority contractors report that programs conducted or sponsored by public agencies often fail to improve their bonding prospects.
5. **Lack of Information** - Even when bonds are denied without deliberate or subconscious discrimination, minority contractors seldom receive clear reasons for such denials nor the kinds of suggestions which would help them meet reasonable underwriting standards in the future.

The bond problems of minority contractors are not limited to being declined when requesting bonding. We have also found that minority contractors are less able to obtain advantageous bond arrangements such as bond lines of credit and effective loss-prevention services. Minority contractors are more likely to pay higher premiums for bonds. Minority contractors are more likely to be steered to government guarantee programs than similar non-minority firms, and these programs are usually more costly and require more time and

documentation. Minority contractors are more likely to be offered bonds with inappropriate and often potentially harmful conditions such as collateral and escrow. Minority contractors often find it more difficult to enlarge or expand their bond capacities. As one would imagine, these conditions present huge competitive disadvantages to even the contractors who can obtain bonds.

In addition to simply studying and monitoring bonding issues, NAMC has undertaken several active steps to improve the bond prospects of minority, small and female contractors.

- We have held meetings with representatives of surety industry associations to identify and implement mutually acceptable actions.
- We provide technical surety guidance and assistance for our members - to the extent that our resources allow.
- We advise state and local government bodies on effective ways to establish and operate bond assistance programs.
- When appropriate, we perform government-funded projects to assist minority, small and female contractors in obtaining satisfactory bond arrangements.

- We have engaged the services of a surety consultant who possesses technical expertise and experience specifically in the issues which surround bonding for minority, small and female contractors.
- We actively support legislative and administrative actions, at federal, state and local levels, which would have the effect of creating more equitable bond opportunities for minority, small and female contractors,
- And, we are constantly exploring new methods to improve the bond prospects of our contractors.

We would respectfully ask this Subcommittee, and indeed the Congress, to support equal opportunity and fair play for the acquisition of bonding for federal construction contracts. At the present time, we would like to make the following specific recommendations:

1. We urge quick passage of the Equal Surety Bond Opportunity Act. We strongly support both of the salient provisions of this act: that discrimination by race, color, religion, national origin, sex, marital status, sexual orientation, disability or age be prohibited in considering Miller Act bonds; and that contractors be notified of the reasons for adverse actions taken on bond requests for federal jobs. When bonds are

required for federal jobs, minority contractors should be assured that their bond applications will be considered without the kind of discrimination that has been prohibited by law in many other areas of business activities.

2. We request a review of the Miller Act threshold which now stands at \$25,000. Inflation has greatly increased the number of very small federal jobs which now exceed the threshold. We have two concerns here:

- Minority, small and female contractors are the ones most likely to seek very small federal jobs; but these contractors encounter the heaviest obstacles in obtaining bonds.
- In this time of great budget concerns, it appears wasteful to spend tens of millions of federal dollars to bond the kind of very small jobs that the Congress intended to exclude by increasing the threshold to \$25,000.

3. We ask the Subcommittee's help in providing more effective technical bonding assistance for minority, small and female contractors. For instance, we believe the Minority Business Development Agency has the potential to help provide such assistance. As part of a surety project

we conducted last year, we gave MBDA detailed advice and recommendations on how to provide effective bond assistance, but to date, MBDA has not provided bond assistance of any consequence. In addition, active implementation of a variety of existing laws and regulations would permit several federal agencies to help provide bond assistance.

4. Finally, we ask the Subcommittee to work with us and with other associations which represent small and female contractors to fashion legislative initiatives which are appropriate to reduce the severe, numerous and persistent bond problems our members face.

This concludes my prepared statement. I would be pleased to respond to any questions you might have.

**STATEMENT
OF THE
AMERICAN
INSURANCE
ASSOCIATION**

STATEMENT
OF

LYNN M. SCHUBERT
ASSISTANT GENERAL COUNSEL
AMERICAN INSURANCE ASSOCIATION

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON MINORITY ENTERPRISE, FINANCE,
AND URBAN DEVELOPMENT

JULY 20, 1993



The American Insurance Association is a national
trade organization of casualty insurers.

PROFILE

The American Insurance Association is a full-service trade organization of casualty insurance companies. In its present form, the association combines three earlier organizations. One of those, the former National Board of Fire Underwriters, was organized in 1866, making it one of the oldest trade associations in the nation.

The various departments provide members with up-to-date intelligence on legislative, regulatory, judicial and technical developments relating to our industry. The AIA also maintains liaison with insurance regulators, federal and state lawmakers, other state and federal government officials, insurance and non-insurance industry groups and media—supplying information and assistance on issues of mutual concern.

A countrywide system of regional offices and local legislative counsel ensures prompt and rigorous attention to casualty insurance matters. At the same time, technical specialists from disciplines as diverse as law, economics and engineering educate members and outside publics on developments that may affect the industry and its services to the insurance-buying public.

STATEMENT OF
LYNN M. SCHUBERT
ASSISTANT GENERAL COUNSEL
AMERICAN INSURANCE ASSOCIATION

BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON MINORITY ENTERPRISE, FINANCE,
AND URBAN DEVELOPMENT

JULY 20, 1993

Access to Surety Bonding by Qualified
Small and Minority Construction Contractors

Introduction

The American Insurance Association (AIA) is a trade association with over two hundred and fifty members and representation in every state. The members of AIA are major property/casualty insurers, and include most of the largest writers of surety bonds for federal construction projects. AIA would like to thank Chairman Mfume for convening this hearing, and for inviting AIA to testify on the important topic of development of small and minority construction contractors through access to the surety bond market. In this testimony we will address the request in your letter to guide you through the underwriting process, including communications with applicants. We also will address how the surety industry has responded to the

need to improve access to surety bonds for small and minority contractors, and the AIA position on H.R. 278 and H.R. 1464.

Surety bonds are an integral part of the process of federal construction, and as such, it is vital that all qualified contractors have equal opportunity to obtain these bonds. AIA is committed to the concept of nondiscrimination in surety bonding on the basis of race, color, religion, national origin, gender, marital status, sexual orientation, disability or age. AIA members do not discriminate on these bases, and do not support any surety who might.

There are, however, legitimate bases on which to determine whether or not a contractor is qualified to obtain a surety bond. A surety bond is not like a traditional insurance policy such as an automobile policy. A surety bond is not a right to which every contractor, despite his or her experience, financial strength, or character, automatically is entitled. Neither is it a right for every contractor to be awarded a federal construction contract, regardless of the contractor's ability to perform the work. A contracting officer's evaluation of the contractor's ability to perform the work is one step in protecting the federal taxpayers' dollars which are at risk on the project. The surety bond is an additional step in that evaluation and protection for those taxpayers' dollars.

Underwriting a Surety Bond

One of the best explanations of underwriting a surety bond appears in the newly published The Law of Suretyship, American Bar Association, 1993. Chapter Four of this book is a comprehensive look into the entire underwriting process. With the permission of the author of that chapter, Stewart R. Duke, Vice President in Charge of Surety for the Fidelity and Deposit Company of Maryland, that chapter is attached to this testimony as Attachment A. This testimony will attempt to summarize the most important steps in the underwriting process.

To understand the process of underwriting a surety bond, you must first understand exactly what surety bonds are. A surety bond is a three party agreement. The three parties are the contractor (Principal), the owner of the project (Obligee) and the surety (Obligor). Each of these parties owes certain duties to the other two. Under the principles of suretyship, since the surety is guaranteeing the performance of the contractor, the contractor is liable to reimburse the surety for amounts paid on his or her behalf. This is true for all types of surety bonds. However, in the context of construction contracts, there are three primary types of bonds.

Types of Bonds

The bid bond is intended to keep frivolous bidders out of the bidding process by securing that the successful bidder will enter into the contract and provide the required performance and payment bonds. If the lowest bidder fails to honor these commitments, the owner is protected, up to the amount of the bid bond, usually for the difference between the low bid and the next higher responsive bid.

The performance bond secures the contractor's promise to perform the contract in accordance with its terms and conditions, at the agreed upon price, and within the time allowed.

The payment bond protects certain laborers, material suppliers and subcontractors against nonpayment. Since mechanic's liens cannot be placed against public property, the payment bond may be the only protection these claimants have if they are not paid for the goods and services they provide to the project.

The Surety Bond Producer

The first step in procuring a surety bond is to find an insurance agent who is knowledgeable about surety bonds. Often when we are faced with a contractor who has been unable to obtain

a surety bond, we find that the contractor contacted an agent who does not specialize in surety bonds, and who, although licensed to sell surety bonds, did not know how to assist the contractor adequately. One of the primary services a surety agent provides to a contractor is to assist the contractor in preparing and presenting the necessary information to a surety company which is the right "fit" for the contractor. Once the contractor does find a surety bond agent or "producer," the contractor and producer put together a package to submit to a surety underwriter. An experienced producer will be able to assist the contractor to assemble the appropriate information, and will know which of its sureties are most likely to be interested in that contractor.

Not all sureties look for the same underwriting criteria, and not all sureties target the same type of contractor. Some underwriters may focus more on road contractors, while others target building construction. Some may be searching for large contractor accounts, while others are searching for smaller contractors. The surety bond producer is the best person to know these niche marketing strategies.

The surety bond producer also will be able to advise the contractor on the basic criteria every surety will require: capacity, capital and character; the "three c's" of suretyship. If the contractor does not have the financial or business

capacity to perform the particular job being sought, the producer can make suggestions on additional personnel or experience which could be helpful. Likewise, if the contractor does not have capital in the business sufficient to sustain the work during the expected term of the job, the producer can advise the contractor on this front. As for character, the contractor is expected to be someone who will honor its commitments to the owner of the project, the subcontractors on the project, and the surety. The producer can advise the contractor as to what type of information best establishes this criterion.

The Underwriter

Once the producer has completed the initial evaluation of the contractor's information and prepared the application package, the package is submitted to a branch office underwriter for review. The first thing the underwriter will want to do is familiarize himself or herself with the operations of the contractor. This usually requires a new account form. This form is approximately four to six pages, and gives a basic overview of the construction company. The information on this form includes how long the contractor has been in business, the owners of the business, the type of work performed by the contractor, examples of previous projects, method of reporting financial information, tax information, a summary of the company continuity plan, bank lines of credit, whether or not the contractor bonds its

subcontractors, and previous surety relationships.

The underwriter also will need resumes of key company employees and owners, a listing of prior bids of the company and who prepared the bids, the results of those bids, and the profits on projects awarded. The continuity plan of the contractor is important to the surety, since many projects are of long duration. If a major owner of the company dies during the term of the project, it is critical to know that the company will be able to continue in existence to complete the project, or fulfill its duty to reimburse the surety if the surety is required to complete the project on its behalf.

The surety will want to review prior tax forms of the company, as well as at least three prior year-end fiscal statements. These statements reveal working capital, net worth, current debt ratios and dividend policies. Most sureties will require that these statements be prepared and signed by a certified public accountant (CPA). A good construction oriented CPA can assist a contractor in establishing a cost control system. This system then can supply readily the information needed to prepare spread sheets and financial statements which clearly reveal whether the contractor is making money on jobs in progress. The contractor's method of accounting and financial records are of primary importance to the surety underwriter.

The surety will review the credit record of the contractor to determine if the contractor pays its debts on time. If the applicant is a general contractor, often the surety will contact subcontractors who have worked for the general on other projects and ask their experience with the contractor. If the applicant is a subcontractor or "trade" contractor, the surety may contact general contractors for whom that subcontractor has worked in order to determine if the subcontractor paid his or her own subcontractors or suppliers.

The last contacts made by the branch office underwriter usually are to owners and architects on prior projects of the contractor. While this is not done in every instance, it does assist the surety in determining the past performance of a new and unknown account.

Once all of this information is reviewed by the branch office, the submission normally is submitted to the home office for review. While requests for small bonds might not require home office approval, to establish new accounts most companies require home office review prior to writing the first bond. Each company differs in the size of bond which is required to be approved by the home office.

Often the home office underwriter is an attorney or CPA, and possibly both. Therefore, the underwriter is likely to have

questions regarding various aspects of the information submitted. These questions are relayed to the contractor and hopefully additional information is submitted to satisfy the concerns of the underwriter. Once this takes place, and the surety is comfortable with the contractor as a potential client, the surety examines the contract documents for the specific job being bid.

While this may seem excessive, contract documents contain a myriad of clauses which can defeat the unwary contractor. If a contractor is bidding for public work for the first time, the surety can assist the contractor by pointing out particularly onerous clauses such as a clause requiring the contractor to indemnify the owner for the owner's sole negligence. Both the contractor and the surety must be satisfied with the contract documents before a bond is written and a bid submitted.

In the event a final decision is made not to write the requested bond, the underwriter will inform the producer and the producer will inform the contractor, most often in writing. The producer also typically tells the contractor just what would be necessary to get a bond. It is in the best interest of both the producer and the contractor for the bond to be written. A recent survey of the National Association of Surety Bond Producers (NASBP) asked the question whether or not members gave written reasons for bond declinations. Of the two hundred and ninety-three respondents to the question, two hundred and sixty-nine

replied that if a surety declined to issue the bond, the member always provided the contractor with the reasons for the denial. Six respondents said they sometimes provide reasons, and no respondent said that they do not provided reasons for denials.

As you can tell from the length of the description of the underwriting process, it is not something which can be completed in a few days. For a new account, a contractor for which the surety has no information, approval of a bond could take a significant period of time. The length of time depends greatly on the completeness of the first submittal. Each time questions arise and additional information must be submitted, the time is extended. This time can be shortened substantially for existing accounts.

Once a surety/contractor relationship is established, the surety will require the contractor to submit current information to keep the file on that contractor up to date. This way, if the contractor needs to apply for a bond for a project which has a very quick response date, the surety normally will need to request only information which has changed since the last submission, and the specific contract documents for that project.

This difference in response time of the surety must be recognized by the new and emerging contractor. If a new contractor decides to begin bidding on public work, it is

advisable to contact a surety bond producer as early as possible and begin assembling the necessary information. This information even can be provided to the surety for tentative approval of a relationship. Then, when a project that the contractor wishes to bid is published, a quick review can allow the surety to make a final decision on that specific job. However, if the submission to the surety is not complete, delays will occur and the bidding deadline might be missed. Proper preparation can prevent this.

Surety underwriting is different for each company. Each company has its own requirements on information to be submitted, its own limitations on how much capital is required to support a certain size project, its own requirements for just about everything involved in the underwriter process. One thing most sureties have in common, however, is the requirement of the personal indemnity of the owners of the contracting company. Since the contractor is required to reimburse the surety for any payments made on its behalf, the surety is concerned about the ability of the contractor to fulfill this obligation. If a surety is called upon to perform on its bond, in most instances, the contractor is in financial trouble.

Therefore, to encourage the owners and principals of the contractor to do everything possible to make the company work, rather than closing up shop and taking a loss, the surety asks the individuals to express their faith and determination through

agreeing to personally indemnify the surety. For a family owned and run company, this indemnity usually will be requested of the husband and wife, and any children and spouses involved in the company. For a partnership, all partners and spouses will be requested to provide indemnity. Corporations are more difficult, but often the principal stockholder or parent corporation provide the necessary indemnity.

Not only does this encourage a surety to write a new account, it often increases the size of the bond the surety is willing to write. Another way to increase the size of the bond which can be provided is by offering collateral to the surety. This is not done on a regular basis by most standard surety companies, but can be used as a mechanism to encourage a surety to take on a new client which it sees as marginal. Once the client has established a track record with the surety, the collateral could be released back to the contractor.

The most important thing to remember about surety underwriting is that it takes a commitment on the part of the contractor to keep comprehensive, up to date financial and business records, and to keep the surety informed of all pertinent information. It is not an easy process to be a bonded contractor, but the protection the surety provides to the taxpayer and subcontractors justifies this comprehensive approach.

Industry Action to Increase Bond Availability

Surety bond availability for small and minority contractors has increased significantly in recent years. This comes from a number of approaches, not the least of which is market competition. Many standard surety companies have made a marketing decision that the small contractor market is profitable, and entails less risk per account. As a result, a number of companies have established specific programs to target small contractor clients. The NASBP conducted a survey earlier this year on bond availability for small, minority and women-owned contracting firms. A full fifty percent of the NASBP members responded to the survey. The responses of those members indicate that one hundred and twelve corporate surety companies actively are writing bonds for small contractors. Those responding members also reported 7,912 small contracting firms which had been provided surety bonds in the last year. Thirteen percent of these contractors were minority-owned, and seven percent were women-owned. Of this total, 2,481 contractors were applying for their first surety bond, and seventeen percent of these contractors were minority-owned and twelve percent women-owned. Qualified small and minority contractors who find their way to a professional surety bond producer are getting surety bonds.

There also are a host of government programs to assist

small, minority and women-owned contractors to obtain surety bonds. The most prominent and successful is the U.S Small Business Administration Surety Bond Guarantee Program. This program is designed to encourage sureties to write bonds for contractors who otherwise do not qualify under the surety's underwriting guidelines, by providing a guarantee that the SBA will reimburse the surety for a percentage of any loss incurred on that bond. Because the program is designed to assist small contractors, the size of the contract for which these guarantees is available is limited to \$1,250,000.

The SBA now has two programs under which bonds are guaranteed, Plan A, the Prior Approval Program, and Plan B, the Preferred Surety Bond Program. The Prior Approval Program was started in 1971, and has been quite successful in increasing the opportunity for small contractors to bid federal construction projects. This program provides up to a ninety percent guarantee to the surety, but requires approval of each bond to be guaranteed. Many standard companies determined that this paper work was too burdensome for the small number of bonds for which they were seeking guarantees. Therefore, the number of bonds available under the program was limited by the number of sureties participating.

To increase these numbers, in 1988, with the participation and support of the surety industry, Congress enacted the

Preferred Surety Bond Program. This program provides only a seventy percent guarantee to participating sureties, but in exchange, provides that prior approval of each bond guaranteed is not required. Rather, each participating company has a guarantee limit with SBA. Many of the participating companies are using this program to write bonds for small, minority and women-owned contractors who do not meet the specific underwriting criteria of the company, but who appear to have the potential to develop that criteria with growth and experience. As of May 30, 1993, for fiscal year 1992-93, this program allowed almost a billion dollars of contracting opportunity for participating contractors. Sureties provided four thousand four hundred and eleven bid bonds during this time through Plan B. As of July 14, 1993, six hundred and eighty-five of those contracts were awarded to the participating small business, and final bonds were written for a total of \$145,309,211 in contract value.

For the Plan B program, from inception to today, twenty-five percent of the final bonds written have been for minority contractors.

The concept behind the program is to assist contractors in getting into the federal construction arena through a bond guarantee. When that contractor has developed the criteria necessary to get a bond in the standard surety market, the surety with the bond guarantee can move the contractor into its regular

system, opening the way for other new, emerging contractors in the guaranteed program. This is a successful long-term strategy to assist contractors in growing and developing.

The U.S. Department of Transportation also has a surety bond program for minority contractors, and the Minority Business Development Agency of the U.S. Department of Commerce offers substantial assistance in obtaining bonds.

In addition to the federal bond programs, many states have similar programs to encourage and assist small and minority participation in state construction contracts.

Further, the AIA, the Surety Association of America (SAA) and the NASBP have instituted a program to address complaints that surety bonds are being unfairly denied small and minority contractors. These organizations have notified the U. S. General Services Administration, who in turn has notified all federal agencies, that if any of their contracting officers believes that a contractor has been denied a surety bond unfairly, the associations will have members of their organizations review the bond application and either write the bond or explain why the bond cannot be written. This same offer has been made to state insurance departments, and the American Subcontractors Association (ASA) and the National Association of Minority Contractors (NAMC). Although few complaints or referrals have

been submitted under this program, those that have universally were resolved to everyone's satisfaction.

In addition to these programs, the surety industry has been working with various trade associations to assist small, minority and women-owned contractors in obtaining surety bonds. AIA, the SAA and the NASBP have been meeting and working jointly with the Associated General Contractors (AGC), the NAMC and the ASA for a number of years. Through these liaisons, educational materials have been developed and distributed, programs have been conducted, and sensitivity to the need for attention in this area has been heightened.

Federal Legislation

One idea ripe for implementation is a program to assist small, minority and women-owned contractors to learn about surety bonding through the Commerce Department Minority Business Development Centers (MBDCs). AIA, SAA, NASBP and NAMC have discussed a pilot program whereby those associations would provide technical assistance to contractors through the MBDCs. The Chairman's pending legislation, H.R. 278, is the perfect vehicle to implement such a program. As you know, this bill would change the Commerce Department Minority Business Development Agency to the Minority Business Development Administration. The bill also provides that funding can be

provided to assist minority businesses in developing management and technological skills. Additionally, the bill calls for the establishment of a surety bond referral assistance program. The bill specifically provides that funding for these types of programs could be granted to trade associations. Funding to NAMC to administer a bond assistance or training program would further the cause of increasing availability and access to surety bonds for minority contractors in a significant measure.

AIA supports H.R. 278, and would like to assist in the implementation of its goals when it is enacted into law.

Another bill pending in Congress which addresses surety bonds is H.R. 1464, sponsored by Delegate Eleanor Holmes Norton. The essence of this bill is to prohibit discrimination in surety bonding on the basis of race, color, religion, national origin, gender, marital status, sexual orientation, disability or age. AIA supports this philosophy, and these provisions of H.R. 1464. The bill also provides that a contractor is entitled to written reasons for any adverse action on a bond request. As discussed earlier, sureties give reasons when they decide not to write a bond, and AIA supports this concept. There are some provisions of H.R. 1464 which are of concern to AIA members. We have met with staff for Delegate Norton and discussed these provisions, and will continue to work to assist in drafting technical amendments which will make the bill acceptable and workable for

all parties.

Conclusion

The surety industry is committed to making surety bonds equally available for all qualified contractors. The surety sells a quality product, and it must be available on a equal basis. Underwriting is a complicated process, and the judgment of the underwriter is required in every instance. Many of the programs discussed in this testimony make it easier for that underwriter to decide that in his or her judgment it is time to write contractors who do not meet the traditional underwriting requirements. AIA will continue to support programs and legislation which assist small and minority contractors to participate in the federal construction field, and which provide ensure that all contractors will have equal access to both the projects and the capital and bonds required to get those projects.

The Law of SURETYSHIP



EDWARD G. GALLAGHER, EDITOR



TORT AND INSURANCE PRACTICE SECTION
AMERICAN BAR ASSOCIATION

ATTACHMENT A

CHAPTER FOUR

HOW CONTRACT BONDS ARE UNDERWRITTEN

Stewart R. Duke

The construction industry in the United States is a vast, multifaceted industry that does projects ranging from paving your driveway for several thousand dollars to huge airport, rail and highway jobs in the billion dollar range. These undertakings are performed by contractors who tell the owner, be that the federal, state or city government, the local county, the hospital district, the library district, the school district or the private owner, I will build that project according to a set of plans and specifications, see that all the bills are paid for all the material and labor that goes into that project. Further, I will build it for a firm price that I have "estimated" today, even though the project may take two years, three years or longer to complete and regardless of what it costs me to do it. I am giving you this fixed price, and will sign a contract telling you that I will build this project within a given time for a pre-determined price and turn it over to you just as the architect and/or engineer has designed it and that all the bills for the labor and material going in to that job have been paid. I, the contractor, have the faith that you, the owner, have the money and will pay me throughout this project, that if you request changes you will pay me additionally for those changes.

This is basically what the contractor undertakes and what we, the bonding company, guarantee.

Our subject today is "How Contract Bonds are Written" --- what the process is from the time a contractor decides he wants to do bonded work, his decision to talk to a particular bond producer, their decision to talk to a specific bonding company, or perhaps several, before one surety is chosen.

I. WHAT THE PROSPECTIVE PRINCIPAL SHOULD DO

A. Determination to be a Bonded Contractor.

A contractor must first decide if he wants to be a bonded contractor. In this process there are two major things that he should consider. The first consideration is that of being a contractor who can furnish bonds almost certainly guarantees that he will be able to obtain work denied unbondable contractors. The second consideration is as a bonded contractor there are certain requirements of the bonding company, a certain amount of ongoing information that must be supplied. Some contractors simply do not like or in some cases have the ability to furnish the information needed by the bonding company,

thereby in effect shutting themselves off from a huge source of construction projects.

1. Public work. When deciding on whether or not to become a bonded contractor or should I say bondable contractor, one must remember that since shortly after the turn of the century when Edwin Warfield convinced the federal government that they should bond all construction projects, nearly all public bodies have been requiring bonds. Almost all public bodies, the federal government, the state government, cities, counties, hospital districts, school districts, library districts and on and on all require projects over a certain threshold level and duration to be bonded. This bonding not only protects that taxpayers money by guaranteeing a project will be completed and the bills paid but first and of paramount importance the bonding process assures a prequalification of the contractor. For the most part the contracting officer for the federal government, the school board, the hospital board or for that matter most public bodies simply do not have the time and/or expertise to prequalify every contractor that wants to bid a project, but by requiring a bid bond and then a performance and payment bond they, the owners representatives, are assured that the bonding company has gone through a prequalification process. This prequalification process is a hidden asset of the bondable contractor and certainly should be taken into consideration when a builder is deciding to become a bondable contractor.

2. Private work. Of less magnitude, less prominence to the bonding company is private work. I say less magnitude, less prominence but certainly not less important. Of my book of contract business approximately 85% of the premium is derived from bonds written on public projects, therefore, 15% of my premium source is from bonds written on private projects. To my knowledge there are no requirements by any governmental entities that private jobs be bonded. There are, in some states, bond forms and certain laws governing private work when a bond is written and filed in the county where the work is performed, but for the most part there are no requirements for bonds on private projects. Fortunately, we are seeing more and more private projects being bonded at the request of the institution financing the project.

We see some very successful contractors who do a lot of private work but unfortunately many times their bonding capacity is severely limited due to slow or hung receivables from private owners. Many times we are unable to write bonds on these private projects because of the onerous terms in the contract or bond form. That is not to say at all that I do not write bonds for contractors who do both public and private work, but in making the determination to become a bondable contractor this is a subject that should be looked at closely.

On public work you are almost always assured the money is available, you will get your estimate and retainage on a timely basis. Equally important to the contractor and surety is that on public work you can normally rest assured that the contract terms and bonds are fair or at least standard and have stood the test of time.

On private work a contractor is faced with less bureaucracy, oftentimes does not have to furnish bonds, but on the other hand may be confronted with onerous contract and bond forms while at the same time struggling to collect his estimate and retainage.

B. Financial Reporting.

Another major consideration in determining whether or not he wants to become a bondable contractor is the type of and sophistication of financial reporting and cost records required. Too many times, in the past, we have had contractors apply for bonds who really did not know if they were making money on a given job or for that matter on any of their jobs. They only knew if they had more money at the end of the year than they had at the beginning of the year, they had a successful year. That sort of record keeping was simply not sufficient for the bonding company who was guaranteeing the completion of all jobs throughout the entire year. The bonding company could not take the chance that some time during the year one, two or more of the contractors' jobs were losing large amounts of money, that could conceivably cause the ultimate failure of the construction company and demands being placed on the bonds.

1. Selection of a CPA. The first step in the actual underwriting process begins with the contractor's selection of a qualified construction oriented CPA firm. A firm that fully understands cost to cost, percentage of completion, overbillings, underbillings, and the proper treatment of unapproved change orders. In other words, a CPA firm that basically speaks the contractor's language. There are CPA firms that are perfectly capable at what they do --- which is not always construction accounting. Construction accounting is like no other, you have no inventory as traditionally known to accounting firms, you are working on estimated percentage of completion to come up with net quick and net worth. In some instances the CPA is looking at completed contract accountings, but the preferred method is of course the percentage of completion method --- none of which is similar to normal retail accounting, if you will. The truly professional construction CPA concentrates on contractors and is closely allied with the contractor's bonding company and bank. When deciding on a CPA firm the contractor should talk to other contractors and interview CPA firms to make certain they can handle his business. They should be able to set up a cost control system for the contractor, a system that can readily supply information with which to prepare spread sheets, not only for the bonding company and banker, but to the contractor himself. Spread sheet information that will tell the contractor, bonding company and banker if the jobs are making money, if the projected, bid profit, is holding or fading. If the contractor sees profit fade on jobs he can immediately address the situation --- more tightly control the costs --- cut overhead or whatever is necessary to return the job to profit.

The contractor's method of accounting and cost records are of primary importance to the underwriting of bonds by the surety company.

2. Other financial considerations.

- a. Bondable contractors always need working capital, so for them to incur unnecessary drain on working capital is counter productive. A number of contractors, particularly those in the heavy or highway arena need tremendous amounts of equipment. From time to time we see contractors who feel compelled to purchase this equipment outright, thereby in some instances totally wiping out their working capital. We find in most instances that

contractors who lease or buy equipment with the long term payout are just as successful as ones who pay cash for that equipment.

When a contractor in the heavy or highway business begins to consider being a bondable contractor, it is most important that he keep in mind the need for working capital and strongly consider leasing or at the very least, stretching out payments as long as possible when purchasing or arranging for equipment.

- b. An indirect financial consideration is the timely payment of bills to creditors and subcontractors. Since the payment bond guarantees that the bills for labor and material going into the job will be paid, we, the surety company, are particularly interested in the bill paying habits of our potential customers. In many instances it is worth borrowing money with which to pay bills. Some time the discount on prompt payment goes a long way toward the interest payments on a bank line, but the main thing is it keeps your pay record clean thereby potentially giving you greater bonding capacity.
- c. Under the category of other financial considerations certainly must come a good banking relationship. Not only will a good banking relationship make it possible for a contractor to finance equipment over several years, it gives a contractor the ability to set up and keep a line of credit or possibly a revolving line of credit. With a normal or revolving line of credit the contractor will, as mentioned above, be able to have money available to take advantage of supplier discounts and be able to withstand a period of bad weather or other work stoppages when no estimates are coming in. It is vitally important that a contractor have a good relationship with his banker.
- d. Another indirect financial consideration is planning for the future with a well funded and well thought out continuity plan. This is best done early in the overall consideration to become a bondable contractor because it is an item in which the bonding company will be very interested. The plan must be set up so the company will not be financially crippled in the event of the death or departure of a major

stockholder or owner. A plan that will leave the contractor with working capital and worth, a plan funded over a number of years is normally the proper way to structure a continuity arrangement. Key man life insurance can oftentimes be the make or break factor when a principal of a construction company dies unexpectedly.

e. When deciding to become a bondable contractor there are certain necessary steps that must be taken, steps that should not, cannot be passed or side stepped. The bonding company is looking for contractors with not only the technical ability to build a building, a bridge, a treatment plant or a road but for contractors with the financial strength to withstand reverses that frequently come in the construction business. Reverses that most often are not of the contractor's own makings, a subcontractor going broke, an owner who does not or cannot pay on time, unplanned for labor disputes, a myriad of things that can cause the contractor such problems that his bond must be called upon to respond.

f. One thing the contractor who is applying for his first bond often does not understand is that the performance and payment bond has few exceptions --- it does not say the bonding company will arrange for completion of the job except for bad weather, except when a subcontractor goes broke, except when an owner is paying slowly, it simply says the contractor will do the job according to the terms and conditions of a given contract and if he is not able to the bonding company will see that the job is completed and the bills are paid. There are, of course, certain covenants in the indemnity agreement indicating what the contractor must do and what rights the bonding company has. This will be covered in other areas of today's program.

II. ROLE OF THE SURETY BOND PRODUCER

A. The Professional Surety Bond Producer.

The discussion of the role of surety bond producer should most certainly be prefaced by a discussion of the professional surety bond producer vs. the surety bond producer.

There was a time when a contractor could retain his brother-in-law, the local insurance agent, or his best golfing buddy who happened to be an insurance agent to help him secure a bonding line with a bonding company. Unfortunately, it is not wise to rely on other than the truly professional surety bond producer. As financial reporting has become more sophisticated and contract terms have become more onerous, it is vital to have an agent, a bond producer, who speaks the language of the construction company and the bonding company, an agent who understands why the bonding company wants a copy of the 1120S, wants to know about locked in capital of a sub S company, understands over and underbillings, profit fades, all the things in which the bonding company is vitally interested.

In addition, the professional surety producer should be active in construction industry organizations so he will be aware of information vital to the contractor and bonding company. He should be involved with various committees within the contractor's organizations to help explain to the contractor various bonding and insurance companies concerns, problems having to do with the products that he sells, mainly bonds and insurance. If nothing else, the professional bond producer will become familiar with other contractors, subcontractors, suppliers, architects, public officials, all the various people that go toward making the relationship between the producer, contractor and bonding company a more knowledgeable one. The selection of a professional bond producer is a must in the overall scenario of how contract bonds are underwritten.

- B. The professional surety bond producers actual role for his customer, the contractor, is one of lending support to both the contractor and the bonding company. His job is to first secure the account, the contractor, for the bonding company and act as the initial underwriter of the account for the bonding company. As with most things, presentation has a great deal to do with the ultimate success of any endeavor. It is the role of the producer to make certain the contractor's experience, credit record and financial condition are presented in the most favorable manner, thus the need for someone who understands what the bonding company wants to see in order to consider an account. In addition to presenting the initial underwriting case to the bonding company, it is the producer's continuing role to gather annual financial information, bank line information, spread sheet information and all the other items needed by the bonding company to be of up to the

minute service to the contractor. On an ongoing basis the producer must furnish interim job progress information obtained from the contractor, should be well aware of any problems the contractor is experiencing, any change in ownership, any major equipment purchases, any changes in the contractor's operation be that a decision by the contractor to look at or think about and perhaps bid work out of his normal operating territory or perhaps a contractor's desire to start doing an entirely different category of work. All the things that go to make up surprises to the bonding company. Bonding companies don't like to find out by reading in the daily newspaper that the stock in one of their contractor's company has been sold to someone else or that a building contractor has taken out plans on a highway job. These are the type of things of which a professional bond producer should be aware and pass on to the bonding company.

The more day to day role of the producer is that of obtaining information for the actual bidding of the work. Obtaining from the contractor information on the contract, bid and final bond forms to be used. In many instances the surety company must review the bid bond form, the contract itself and the performance and payment bond forms, therefore, the producer must be able to obtain and understand this information prior to passing it along to the bonding company.

III. ROLE OF THE COMPANY UNDERWRITER

- A. The initial role of the company underwriter is one of becoming familiar with the proposed contractor's account. This process normally begins with the bond producer's submission of the contract account to the local branch office of the bonding company. As mentioned earlier the initial presentation is highly important. It is often the very first time the bonding company has seen this particular account, therefore the information and presentation by the bond producer must give the bonding company not only an overview of the entire construction operation, but a feeling of comfort in order to proceed with the consideration of the account.

The bonding company will probably want a new account profile form completed, a form that will be 4 to 6 pages which gives a quick overview of the construction company. This will tell the bonding company how long the contractor has been in business, who owns the business, lists the type of work done, some of the

larger jobs completed with names of owners, the method of reporting financial information, the method of paying taxes, has a brief discussion of the continuity plan, bank lines of credit, explains ownership and function of any affiliated companies, lets the bonding company know if they normally bond their subcontractors and certainly not least discusses prior surety company relationships.

In addition to this profile of the construction company itself, the bonding company will frequently need profiles and/or resumes on the owners and key employees. The success or failure of individuals in prior operations can, in some instances, be a major consideration by the bonding company. Many times when submitting a proposal to the bonding company the contractor will include a very comprehensive listing of prior projects bid by various individuals within his organization. A listing showing the projects bid, their standing in the bidding, be they low bidder, second bidder, etc., etc. In addition to this list of projects bid, we many times see a listing of recent jobs obtained and completed showing the gross and/or net profit on each job. This sort of information is invaluable to the prospective bonding company as it gives them a quick overview of strengths and weaknesses in the bidding process of the potential new contract account.

The bonding company normally asks about and wants copies of the construction firm's continuity plan. The plan that enables the firm itself to continue to operate, financially strong, in the event of the departure or death of a major owner. As mentioned earlier, the bond has few exceptions. If the bonding company is on a large, long term job and a major owner dies and the company is obligated to purchase back his interest in the company, there can be a major problem for the continuance of that construction operation and specifically that large, long term job on which the bonding company has a bond. Therefore, the bond underwriter is vitally interested in the prospective contractor's continuity plan. Does it allow for a long term buy back of the departing owner's interest, will this buy back destroy the contractor's working capital and worth --- is there life insurance to fund this buy back in the event of a death --- is there a mechanism in the continuity plan to extend the buy back of the departing owner's interest -- say 5 to 10 years. In other words, can the bonding company feel secure in the knowledge that the construction company will continue

to be a viable entity to complete that large, long term job in the event a major owner dies or departs the operation.

The bonding company will ask for copies of prior tax returns, particularly if they are looking at a sub S corporation to see the actual taxed surplus locked in.

At least three prior fiscal year end financial statements are most frequently requested by the bonding company. Financial statements prepared on a percentage of completion basis which include spread sheets on jobs under way and those completed during the fiscal year end ending at that particular period. With these spread sheets the bonding company can track jobs bid, see if the original bid profit is holding up, see if there is profit fade and see if there are overbillings or if there are underbillings. The bonding company can normally tell by looking at three fiscal year end statements if a prospective new account is growing too rapidly, is increasing debt at too rapid a pace, is making or not making money. Three statements give a quick comparison of working capital, net worth, current and debt ratios, dividend policies, all the items that go to the maintenance of and increasing of bonding capacity.

Next the bonding company will check out the new client's credit record, his bill paying habits if you will. Inasmuch as the bonding company in effect is guaranteeing the contractor will pay his subcontractors and suppliers, they are vitally interested in this facet of a contractor's activities. Often suppliers and subcontractors are contacted directly to gather this information. Many times the bonding company will contact subcontractors who have done work for the prospective bond account. Often the subcontractor will tell us a contractor pays on time, slow or just how he pays his bills. The opposite is true when the bonding company is considering a trade contractor, we contact various general contractors for whom the trade has worked to see what kind of reputation he, the trade contractor, has for doing his job and paying his subcontractors and suppliers.

In certain instances prior owners and architects are contacted to give the bonding company a greater comfort level. Often in the new account profile mentioned earlier, there is a place to list architects and prior owners so the bonding company readily has this information to use at its discretion.

- B. Following the branch office initial contact and review of the prospective new contract account it is normally forwarded to the bonding company's home office. Various bonding companies have different levels at which the branch must send papers to the home office. For this discussion we are assuming the account is of a size that must be submitted to the home office.

In a great many instances the submission sent to the home office by the branch is thorough enough that few additional questions are asked. The larger and more complicated the account of course determines the amount of home office involvement. Since many home office underwriters are attorneys and CPAs and in some instances both, they will often find things in the financial statements, continuity plan, bank notes or security agreements, etc., etc., about which they would like greater information. That word information is one that is often discussed by the bond producer and contractor. When I say discussed, the discussion is usually "Why does the bonding company want so much information?" It is pure and simply, the bond underwriter in the branch or home office many times finds information within a certain document that may cause a bond loss. For example we are frequently told that a bank loan is long term, therefore, the due date should not effect working capital but by examining the bank note and security agreement we find that the note is due with 13-15 months. That is long term according to accounting rules, but if we bond that contractor on jobs that will last 2-3 years it is possible, and we have seen, that note not being renewed thereby wiping out the contractor's working capital. We find by close examination that many times the stock in the construction company is held as collateral on a loan leaving the surety in a pretty bad position should there be a default.

In close examination of specific jobs we often find major fades in the original profit, we find jobs not completed timely, going into the penalty phase. Sometime when looking at gross profit on all the contractor's jobs on hand, we find it is less than the contractor's historical overhead and determine that as long as he continues to get work, can keep cash flow, things are okay, but if he goes for several months without getting a job it would not take long for major problems to occur. We find the continuity plan is set up to pay out in one year, which would some time totally deplete the working capital and a large part of the contractor's worth. There are a myriad of items

that can be gleaned from simply close examination of various pieces of information requested by the bonding company. Pieces of information that may not only circumvent a loss to the surety company but oftentimes be of tremendous assistance to the contractor himself.

After the initial underwriting by the branch and home office underwriter, after all that information has been sifted through, all those questions answered satisfactorily and a contractor/bonding company relationship has been established oftentimes comes --- more questions on specific jobs, specific contract documents and specific bond forms. Bonding companies are frequently accused of wanting too much information but in the overall scheme of surety underwriting, information supplied to the bonding company may not only prevent a bond loss but can save the contractor from disaster. On larger jobs we normally review the construction contract and bond forms in the home office. To my surprise I have had contractors say things like, "You really read those contracts, don't you?" when we point out to them a particularly onerous contract or bond term, a long term warranty, a defeasance clause, a declared default provision in the bond, a totally unreasonable hold harmless and/or indemnity clause, things each of which could cause major repercussions to the contractor and possibly to the bonding company.

I call the system of first review by the branch followed by home office review a system of checks and balances. I feel that the role of a company underwriter is not only to protect his company from a loss but also help the contractor protect and preserve his company, his worth. The role of the company underwriter, in my mind, is not one of an order taker, not one of simply a bond writer, but as the name implies, an underwriter. A person who looks at all the financial figures, the credit experience, the bonding relationship, the technical expertise and makes an underwriting decision --- an educated, well thought out decision that will benefit both the surety company and the contractor client.

The underwriting of surety bonds is not an exact science as evidenced by some of our recent loss ratios, however, underwriting can be refined, through the cooperation of the producer, the surety company and the contractor to a point where we can each prosper and hold losses to a minimum. In this process the role of the producer, the role of the company underwriter and of course the role of the contractor all mesh into this

system, uniquely American, that enables our construction industry to be one of the largest most diversified and innovative on the face of the earth.

IV. INDEMNITY AND COLLATERAL

- A. Indemnity to the surety will be covered in greater depth during other parts of today's program, so I will not get into the legal aspects at all. My discussion is based on outside indemnity, not the normal indemnification of the surety by the construction firm itself.

I will simply point out that as surety we prefer and for the most part obtain personal indemnity on most construction corporations and partnerships. Aside from the legal ramifications of the indemnity and indemnity agreement, which will be discussed in depth later. We feel that it is a manifestation by the stockholders and/or partners of a construction firm, that they are fully behind their company and have faith enough in their company to, as we say, "get on the line".

Since American construction companies are for the most part family owned, many times with the father, his wife and their children all involved in the construction company, devoting almost their entire life to the endeavor, it is normally not a difficult task to obtain personal indemnity of those involved. This is, of course, not the case in publicly held corporations and too, many of the publicly held corporations have a huge net worth and make outside indemnity unnecessary.

As I said, the indemnity of the major principals is in a great measure a manifestation of their faith in their construction company. Having said this, it must be said that in some instances the additional outside indemnity by the principals can increase the bonding capacity somewhat. For the most part the bonding capacity is predicated upon the worth and working capital in the principal corporation itself but occasionally this can be increased by adding the worth and working capital of outside principals who give their personal indemnity.

Although we see very, very few construction companies who are limited partnerships, in that event we do obtain the additional personal indemnity of the limited partners. This of course is for basically the same reasons as outlined above to indicate to us that they are willing to stand behind their construction

operation and in some small measure lend financial strength to the working capital and worth of the front line construction company thereby giving potentially greater bonding capacity.

Again, we ask for and obtain outside indemnity, usually from individuals on the vast majority of our accounts and do in some cases recover part of our loss from those indemnitors.

Finally, and perhaps most important, the principal and outside indemnitors must be instructed to read and acknowledge an understanding of what they are signing when they sign an indemnity agreement. Recognize their responsibilities and rights as well as those of the bonding company.

B. Collateral

The use of and determination of when to use collateral differ in the underwriting and claim areas. Collateral in the claim situation, under the indemnity agreement, will be discussed later in this program.

From an underwriting standpoint the use of collateral is normally not a consideration. In the first place contract bonds must be written on the merit of the applicant, the financial strength, experience and credit worthiness of the applicant. If an applicant lacks any one of these features and we do not feel comfortable enough to write the bond, the use of collateral certainly does not enhance the risk. Of primary concern, as I have mentioned repeatedly is working capital and net worth, therefore we feel that requiring a contractor to post collateral in effect reduces his financial capabilities to finance and complete a given job.

Rather than confuse the issue on collateral for surety bond underwriting I feel it fair to say that for the most part it is not done.

V. REINSURANCE

The ability to spread the risk and prevent catastrophe through reinsurance is in my mind one of the most important facets of the surety industry, particularly today, as the contracts and bonds are larger than ever before.

Through the process of reinsurance the primary company gains capacity to handle bonds larger than it's appetite for risk on a single bond would normally allow. Reinsurance also gives capacity for the primary company on bonds that are larger than allowed by its authorized capacity. Capacity or size of bond as authorized by the U.S. Treasury List, which allows the bonding company to write a single bond no larger than 10% of its policyholder's surplus. For example, until July 1, 1993, the Fidelity and Deposit Company of Maryland is able to write a single bond of around \$24,000,000 based on the 10% of our approximate surplus of \$240,000,000 at December 31, 1991. Some states and departments within the state, some cities and counties have similar prequalification criteria. I know of one state department of transportation that annually published a listing of companies authorized to write bonds on highway work at 20% of surplus figure, or in the case of the F&D about \$48,000,000, however, at that time they allowed no use of reinsurance. If the F&D, for example, wrote a bond of \$105,000,000 rather than letting us sign the bond alone and relying on reinsurance, that Department of Transportation wanted all the capacity on the front line of the bond or all the reinsurers named in the bond itself to aggregate the \$105,000,000 capacity.

We run into this from time to time when some state, county or city will require that all the capacity be on the bond itself but for the most part owners, be they public or private, rely on the reinsurance system as traditionally and customarily used in our country, of which there are two, treaty reinsurance and facultative reinsurance.

A. Treaty Reinsurance.

1. Any discussion of reinsurance must begin with an understanding of treaty reinsurance. That which is in effect, automatic. Reinsurance that the primary front line surety has in place to be used automatically up to a pre-determined size. This is an agreement, a contract, a treaty if you will, between the reinsuring company and the primary company that says basically that we, the reinsuring company, will accept a share of all bonds you write over a certain amount, except a very few classes specifically excluded, which may be written only by special exception or direct submission and specific underwriting. In all other cases the reinsurer will accept his share automatically. In other words the reinsurer has underwritten the primary company and feels comfortable with it's underwriting ability, it's book of business, it's expertise, it's ethics,

comfortable enough to, as we say in the surety business, "give them the pen" and commit their, the reinsurers, financial statement on bonds.

There are very few sureties that keep a large portion of any given bond. The vast majority of sureties will keep the relatively small bonds then reinsure on a percentage basis all bonds over that base retention amount. We oftentimes see a surety keeping the small bonds, then on all bonds over that size they will keep a given percentage then reinsure out among several professional reinsurers various percentages equal to the total of that percentage that they do not keep themselves. For example, on a bond of say \$2,000,000 the writing company may keep \$1,000,000 and by pre-arranged automatic treaty cede off to five other companies, professional reinsurers, various percentages that total the remaining \$1,000,000, thereby totally covering that \$2,000,000 bond. Again, this is all done automatically under the pre-arranged treaty.

Since many of the professional reinsurers have similar arrangements with a number of primary bonding companies, it is evident that they would build up a huge book of business, therefore to protect themselves, to give themselves capacity they also have treaties with other reinsurers and retrocede portions of their risk on up to other companies in a manner similar to the arrangement between the primary company, the company whose name is actually on the bond and the first line professional reinsurer.

2. The other most common form of treaty reinsurance is the excess of loss which may take several forms such as excess over a given aggregate loss, a specific occurrence loss on a given account or even an excess over a specific loss on a given pre-set amount. Briefly this form of excess coverage, catastrophe coverage, keeps the primary company from incurring loss over a given amount on their entire book of business, an account or bonds of a given size. In other words they will take care of all losses aggregating for example \$50,000,000 and above that the reinsurers will pick up the losses. Perhaps I should say the reinsurers may pick up the losses because we sometimes see first, second or even third excess of loss coverage. For example, the primary company may decide to keep all losses on contract bonds up to \$25,000,000 then purchase an excess of loss coverage for the next \$25,000,000 worth of

losses and a second excess of loss cover for the next \$25,000,000 thereby giving them total protection on losses of up to \$75,000,000. The question then arises, "Are we going to have losses aggregating \$75,000,000?" because if they do then these losses will come back to the primary company as unreinsured losses! The subject of treaty reinsurance is a broad, wide-ranging one, one that could be carried on ad infinitum, but suffice it to say, it's a system that has worked well for the primary surety company, the construction industry, the owners and material suppliers, a system that has given our market capacity to handle some extremely large bonds.

B. Facultative Reinsurance.

1. Unlike treaty reinsurance, where the reinsurer underwrites the primary company itself, facultative reinsurance is a system whereby each risk is specifically underwritten.

Facultative reinsurance most often comes into play when a primary company has a risk, a bond, of a size that is greater than the aggregate amount which can be written within the limits of its own capacity and that of its treaty. An example might be on a \$150,000,000 bond, a primary company within its appetite and within its treasury limit may keep \$50,000,000, reinsure with its treaty the next \$50,000,000 but have to go to the market to obtain the remaining \$50,000,000. This is done on a facultative basis, which is really no more than going to other primary companies and offering them, with a special underwriting package, a portion of that \$50,000,000 of coverage needed. The home office underwriter will typically send submissions to six or seven other primary companies asking them to participate on the bond and the other companies normally come back and accept varying amounts totalling up the \$50,000,000 needed, or sometime greater, but within a relatively short time the entire \$150,000,000 bond is covered thereby spreading the risk among the primary company who is actually writing the bond, possibly five to nine reinsurers who are on the primary company's treaty and possibly five to seven facultative reinsurers.

Today we have discussed "How Contract Bonds Are Underwritten". Granted, it is a subject difficult to cover in the relatively short period of time allotted, a subject in which all the subjective points can in no way be fully addressed. A process, as I have said, that is uniquely American, a process that served and will continue to serve the construction industry, public owners, private owners and the credit industry well. A process that is understood by few, frequently under fire by many, but one that I feel will prevail.

B I O G R A P H Y

STEWART R. DUKE

VICE PRESIDENT IN CHARGE OF SURETY DEPARTMENT

FIDELITY AND DEPOSIT COMPANY OF MARYLAND

Graduated from high school in 1949. Summer jobs for several years and first job out of high school was in general construction business.

U.S. Navy 1950-1954.

1957 graduate of the University of Houston.

1957 joined Fidelity & Deposit Houston Branch as trainee.

1962 San Antonio Service Office as Manager.

1972 St. Louis Branch as Manager.

1977 Chicago Branch Manager.

1979 Houston Branch Manager.

1983 Houston Resident Vice President.

1986 Chesapeake Branch Resident Vice President in Columbia, Maryland.

January 1, 1988, Home Office Vice President in charge of Surety Dept.

Mr. Duke is an often requested speaker by various organizations throughout the country. Recently he has addressed the National Associated General Contractors, the National Associated Builders and Contractors, Institute of Electrical & Electronic Engineers, National Association of Surety Bond Producers, The American Surety Association, Construction Industry Presidents' Forum, the American Institute of Public Accountants, International Credit Insurance Association, Maryland Association of CPA's, Small Business Administration, Washington, D.C., various construction oriented seminars and agents group.s

He lives in Western Howard County, Maryland with his wife Donna and 14 year old daughter. He has three grown daughters, including twins who are school teachers in Houston, and four grandchildren.

He is an avid gardener and antique collector.

Due to seven moves with the F&D he has spent a lot of time landscaping, repainting and redecorating houses.



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Statement of

The American Surety Association

Submitted for the hearing record

to the

House Committee on Small Business

Subcommittee on Minority Enterprise, Finance and

Urban Development

Regarding

Equal Opportunity in the Surety Industry

and

The Equal Surety Bond Opportunity Act

July 20, 1993

The American Surety Association (TASA) is a group of professionals joined together to promote and ensure the ethical development and enhancement of the specialty surety industry. Specialty surety is that segment of the surety industry dealing specifically with contractors that are unable to obtain bonds in the standard market. In other words, the primary focus of TASA members is to provide surety solutions for small, minority and emerging businesses and we appreciate the Subcommittee's interest in this important issue.

TASA membership consists primarily of surety companies and agents. Other members are professionals associated with the surety industry such as claims attorneys, construction consultants and disbursement control services. All of our surety company members are licensed and treasury listed. Specialty surety companies are subject to exactly the same rigorous tests and controls that the Department of the Treasury applies to standard market companies. The prices charged by specialty surety companies are subject to the exact same regulations as those that govern the prices of standard market companies.

TASA believes that qualified contractors have a right to obtain bonds from reputable companies at a fair price. The specialty surety industry exists to meet that need.

What is a "qualified" contractor?

Underwriting standards differ from surety to surety, and may even change within a surety from one time to the next. Why? Mainly because surety is not insurance. That means that maximum surety premiums are frequently determined by law. Surety companies must decide how much risk they are individually able to accept based on the allowable price. Insurance companies will generally raise the premium to fit the risk. (For example, if you have a car accident, the insurance company might raise your premium or cancel you.) Surety companies, on the other hand, have very little leeway in regard to price. And, many factors may change the amount of risk the surety is able to accept at any given time. Volatility in the construction industry is one of those factors. Underwriting standards may change accordingly.

Because underwriting standards change, there is not necessarily a "checklist" to determine which contractors are qualified. This may be a source of frustration to contractors, especially with the first application. However, despite changing underwriting standards, many basic criteria remain the same. For example, most of TASA's members write bonds for small contractors through the SBA's Surety Bond Guarantee Program. Prequalification requirements of the SBG program are outlined in their Standard Operating Procedures. This information is available for public inspection by contractors or other interested parties. Changes to the SBG program requirements are made necessary from time to time in adjustment to the economy or the construction industry, but are fairly static.

Outside the SBG program, in general, the underwriter will request enough information to prove that the contractor will be able and willing to complete the job satisfactorily and on time. The industry has long relied on the "three C's" to describe the prequalification process: Character, Capacity and Credit. In practice, the following kinds of information go into the determination.

Character - Has the contractor been convicted of a felony in the past? Is the contractor on probation? Has the contractor falsified his application in any way? Has the contractor been honest in all prior dealings with the agent and the surety? Has the contractor failed to disclose information which would be material to his application such as risky personal investments?

Capacity - Does the contractor or his employees have the necessary technical experience for the job? Does the contractor have the administrative resources to manage a job of this size? Is the contractor thoroughly familiar with the local laws in the area where the job will take place? Does he have the necessary equipment and personnel for the job? If not, does he have the capital to acquire what he needs? Does the contractor have enough, or access to enough, working capital for the job. What other jobs or financial obligations will the contractor have over the life of this project, and how are those likely to affect this job? Any risky personal investments? Any risky company investments?

Credit - Does the contractor owe money to another surety? How old are the contractor's payables? Is there pending litigation? Are there other outstanding claims? Are there favorable references from suppliers, subcontractors and laborers? Does the contractor have a good relationship with his bank?

The questions above are intended to provide a general overview of the kinds of factors that enter into qualifying a contractor for surety credit. Each surety company has different standards and each agency may have qualifying criteria. Also, the agent's relationship with the surety and with the underwriters is very important.

Some factors that are likely to disqualify an applicant from consideration are as follows:

- o Prior construction related bankruptcy
- o A prior surety loss where the surety hasn't been paid in full
- o A pay record where the majority of payables exceed 90 days
- o Federal or state tax liens presently in place
- o A stockholder or corporate officer who is presently under parole, indictment or probation
- o A lack of community stability, i.e. contractor has been a resident of the community for some time, but does not own property.

With assistance from an experienced agent, a contractor can overcome almost any weakness in his application, even a

conviction. In order for that to be possible, however, some subjectivity must remain in the prequalification process. Significantly fewer contractors would be bondable if all of the criteria were fed into a computer that handed down the decision. The "Character" criteria is one that has been subject to particular scrutiny. However, based on the questions above, it becomes clearer that assessing character is rarely the most subjective task.

How can the industry assist contractors?

The first and most effective way in which the industry assists contractors is through the agent's working relationship with his or her customer. Surety bond agents have a great deal of knowledge about the construction industry. Many of them actually have experience as contractors or working for contractors. Agents understand the unique pressures and tensions in the contracting firm. Agents have also learned the value of working with a contractor to correct deficiencies. This is especially true for the specialty surety agent for a number of reasons.

There are rarely any other customers or product lines to support the specialty surety agent's business. The agent must try to make a surety bond customer out of every small contractor or he will go out of business. The industry is extremely competitive, especially considering that contractors do not need to use an agent in their immediate area. A person would not enter into the

specialty surety business unless they were willing to commit a significant portion of their time and resources to contractor education and development. The specialty surety agent does not have the option of saying a particular contractor is "not worth it" if he or she wants to stay in business. If there is any way for a contractor to obtain a bond, the specialty surety agent will find it.

Also, specialty surety agents have a very specific expertise in solving the problems unique to small, emerging and minority contractors. After years of working with small contractors, the agent is knowledgeable about a great variety of surety solutions not normally used in the standard market. The agent also assists the contractor by keeping abreast of changing underwriting standards, and always knowing which surety best fits the customer's needs.

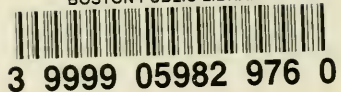
Other than fostering and promoting working relationships between agents and contractors, the industry is assisting contractors on various fronts. Surety trade associations are working with contractor associations on educational programs, industry standards and referral programs.

TASA, specifically holds two contractor workshops annually. The focus of these workshops, which are free to contractors, is to provide a forum in which small and minority contractors having bonding difficulty can get confidential advice from an expert

without any obligation. Our workshops are voluntarily staffed by agents, attorneys, accountants, disbursement control service representatives, and other consultants. Sometimes a topic of interest to contractors is discussed in a open session before confidential sessions begin. There is absolutely no selling allowed at TASA workshops. All volunteers remain anonymous unless the contractor wishes otherwise.

TASA also has an 800 number Bond Hotline for contractors (1-800-296-9393). Contractors having difficulty with bonding, seeking specialty surety agents should call the hotline for a referral. TASA provides a list of surety companies and agents according to the geographical specifications of the contractor. TASA staff members follow up with the contractor, by telephone and in writing, to ensure that the contractor received the required assistance. Responses are strictly confidential unless the contractor wishes otherwise.

To date, three contractor workshops have been held and the Bond Hotline has been in place since May of 1992. TASA has advertised both services to National Association of Minority Contractors, American Subcontractors Association, Women Construction Owners and Executives USA, all of the SBA SBG Regional Offices, all of the Minority Business Development Agency Offices, and no less than 150 8(a) contractors in the immediate vicinity of each workshop. TASA has also offered to bear the expense of advertising to contractor association members, if those



associations would provide a mailing list.

Unfortunately, the response to these programs has been extremely disappointing. Nevertheless, TASA plans to continue trying to assist contractors in this way, and we welcome suggestions. We are looking forward to participating in the surety bond referral assistance program suggested by Chairman Mfume in H.R. 278

What can Congress do to help?

Currently, the program proven most effective at assisting contractors is the Small Business Administration's Surety Bond Guarantee Program. Very nearly all of TASA's members participate in the program because we have found it to be extremely advantageous for small and emerging contractors who would not otherwise be able to obtain bonds. Congress' support of the SBG program is of the utmost importance to us and to our customers.

New programs and laws that can help are proposed in two pieces of legislation now pending:

The first of these is H.R. 1464, "The Equal Surety Bond Opportunity Act." TASA believes that discrimination is no less likely to exist in the surety industry than in any other industry in the country. Nor is it more likely. The written disclosure requirements of H.R. 1464 provide a realistic tool with which customers can prove that discrimination has occurred. TASA has

been working with Congresswoman Norton to make sure that certain aspects of the bill do not unintentionally decrease competition in the specialty surety market by driving companies and agents out of the higher risk business of bonding small and emerging contractors.

The second bill is H.R. 278, "The Minority Business Development Act of 1993." TASA supports this legislation which would improve access to capital, and to management, financial and technical information. Such programs are fundamental to the successful development of all small businesses, and TASA will explore ways in which we can further this goal. We can be most effective in assisting with the development of the surety bond referral assistance program, and we are looking forward to an invitation to do so.

In conclusion...

Our intent is not to argue whether or not discrimination exists in the specialty surety industry. TASA represents surety companies, agents and consultants whose business it is to write bonds for small, minority and emerging businesses. These businesses are our customers specifically. If they perceive that they are treated unfairly or that we are unwilling to conduct business with them, that is not in our best interest. If we do not do business with small business, we go out of business.

We in the specialty surety industry are doing everything in our power to find and assist contractors that are having difficulty obtaining bonds. We are in support of any measure that will aid our mission.

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